REPORT OF THE
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

The Virginia Retirement System's Investment in the RF&P Corporation

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 53

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Preface

House Joint Resolution 392, passed during the 1993 legislative session, requested the Joint Legislative Audit and Review Commission (JLARC) to study the investment practices of the Virginia Retirement System (VRS). A major focus of the study mandate was on the retirement system's $380 million investment in the RF&P Corporation.

This investment raised concerns among State legislators for a number of reasons. Chief among these was the perceived risk that VRS inherited in acquiring a railroad turned real estate company whose most valuable assets include large amounts of undeveloped land. These concerns were heightened because VRS failed to properly inform the General Assembly of the purpose and long-term benefits of the acquisition.

This study found that the Board of Trustees acted reasonably in acquiring the RF&P Corporation given the value and strategic location of RF&P's key developed properties in Crystal City and the substantial income-producing potential of the company's undeveloped 310-acre site at Potomac Yard.

However, if the long-term potential of this investment is to be realized, RF&P staff will have to successfully manage the risks associated with this project. The most significant of these risks is the company's implicit tax liabilities which, if triggered, could cost as much as $450 million. In addition, RF&P staff will need to negotiate favorable zoning terms for its raw land at Potomac Yard, work out satisfactory agreements with the National Park Service and local officials on infrastructure issues, and keep development costs at a reasonable level.

It is essential that the Board of Directors for RF&P resolve a number of organizational and management problems within the company which were identified during this study. Among these are the unwillingness or inability of some senior staff members to adjust to the new corporate mission, an inefficient and ineffective organizational structure, insufficient attention to basic administrative policies, and company instability created by the interim, part-time status of the company's chief executive officer. RF&P's Board of Directors and the company's senior management have initiated a plan to address these problems and will be reporting to JLARC during 1994 on progress made.

Finally, because RF&P is a private corporation, VRS Board members face a significant challenge in developing a system to ensure that this company is both properly run and held accountable to its sole shareholder, the Virginia Retirement System. To accomplish this, VRS should develop strong oversight and reporting requirements for RF&P and ensure that the investment and development decisions of the RF&P Board of Directors are free from political interference.

On behalf of the Commission staff, I wish to acknowledge the support and cooperation by the governing boards and staff of the Virginia Retirement System and the RF&P Corporation.

Philip A. Leone
Director

January 12, 1994

JLARC Report Summary

THE VIRGINIA RETIREMENT SYSTEM'S INVESTMENT IN THE RF&P CORPORATION

January 1994

Joint Legislative Audit and Review Commission

A Report in a Series on the Programs and Performance of the Virginia Retirement System

House Joint Resolution 392 directs the Joint Legislative Audit and Review Commission (JLARC) to study the investment practices of the Virginia Retirement System. A major focus of the study mandate is on the retirement system's investment in the RF&P Corporation. A review of the RF&P investment was of particular interest to the General Assembly because of concerns about the soundness of the investment.

In May of 1990, the Board of Trustees for the Virginia Retirement System (VRS) began the process of acquiring the RF&P Corporation through a transaction in which the company's railroad assets were sold to CSX. With the completion of a complex series of asset and stock purchases and a tender agreement in October of 1991, the State's retirement system became the owner of the RF&P Corporation, whose primary assets were now real estate.

The unique nature of this acquisition has sparked considerable debate and some concern about the retirement system's ownership of RF&P. The concerns and debate about the investment were due, in part, to a lack of information about the acquisition available to the General Assembly. While there is no requirement for VRS to inform the General Assembly of its intent for each individual investment it may consider, the unique nature of the RF&P investment and the General Assembly's ultimate constitutional responsibility for the retirement system should have prompted the VRS to better inform the Legislature of the purpose and long-term benefits of the acquisition.

This report presents the results from JLARC's analysis of the RF&P investment. The JLARC review of RF&P was broadly designed to address three major concerns related to the investment in RF&P: (1) did the Board properly discharge its fiduciary responsibility when making the decision to acquire the company; (2) is RF&P a prudent and sound investment for a public pension fund like VRS; and (3) is the use of a holding company the most appropriate mechanism to safeguard or manage the State's interest in RF&P.

Because of the complexity and scope of this review, two approaches were used to complete the evaluation. First, JLARC staff examined the investment decisionmaking process that was used by the Board of Trustees over the 18 months in which the investment was evaluated, as well as the internal organization and management of RF&P. Second, in light of the special expertise required when evaluating real estate, corporate tax laws, and corporate structure issues, JLARC procured the services of two groups of consultants with experience in these areas to assist the study team in its review.

The Soundness of the Retirement System's Investment in RF&P

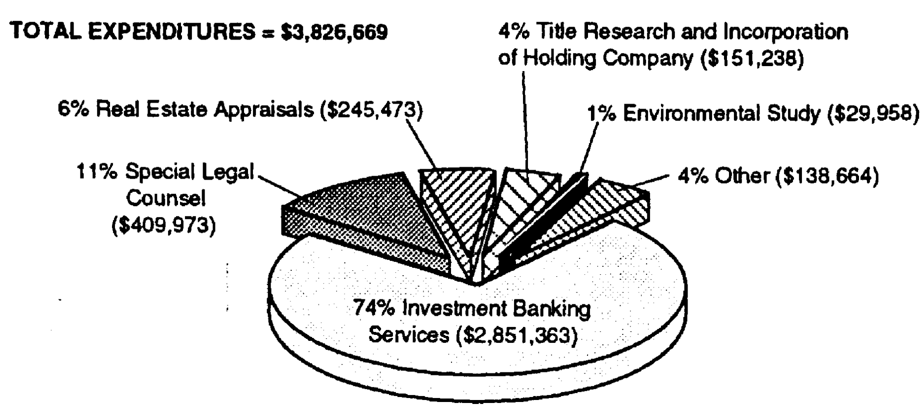
Although the price the Board of Trustees paid to purchase RF&P presently accounts for less than three percent of the total assets of the pension fund, this acquisition represents the largest and most complex single real estate investment which VRS has ever made. Partly as a result of this, concerns have been raised about the quality of the investment, whether the VRS Board of Trustees obtained the necessary professional advice when it acquired the RF&P, and whether the decision to acquire the RF&P was reasonable given the information available to the Board.

Reasonableness of the Acquisition of RF&P by VRS. As trustees for the retirement system, the VRS Board has a legally binding fiduciary duty to protect pension fund assets by exercising the necessary prudence and skill when considering any investment. Given this responsibility, the nature and structure of the RF&P acquisition imposed special demands on the Board of Trustees.

In general, the information reviewed for this study shows that the Board did properly exercise its fiduciary duties associated with evaluating the RF&P investment before the company was acquired. In evaluating the acquisition, the VRS Board spent $3.8 million to procure the services of special legal counsel, several financial and real estate experts, and a firm specializing in environmental liability studies. Based on the advice the trustees received from these advisors, and the given assessed value of RF&P's assets, the Board acted reasonably in deciding to acquire the company.

Completely apart from the question of whether the VRS Board of Trustees hired the appropriate experts to evaluate this ac-

Professional Services Procured by VRS During the Acquisition of the RF&P Corporation



quisition is the issue of whether it was reasonable for the Board to purchase the RF&P. The JLARC consultants estimate the value of the VRS interest in RF&P is $478.6 million. Therefore, the decision by the Board to spend $379 million to acquire the company appears reasonable and prudent.

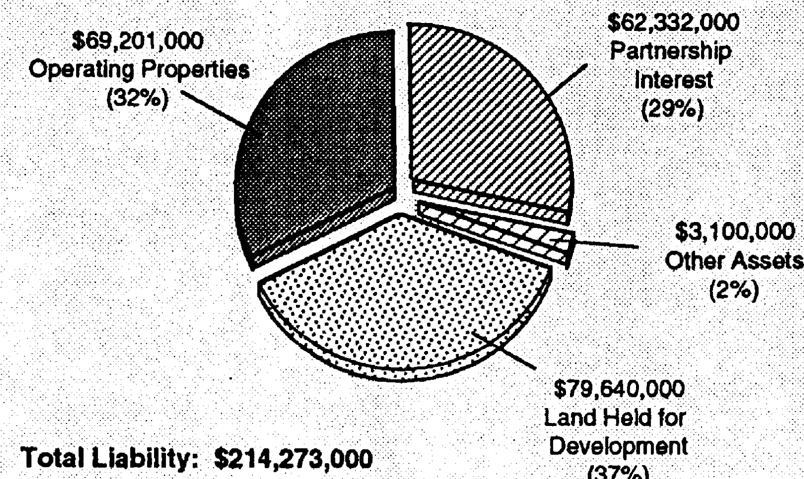
The Impact of RF&P's Deferred Tax Liabilities. Currently, RF&P has two substantial deferred tax liabilities. One is based on the potential gain associated primarily with the appreciation in its real estate assets. The other potential liability, which RF&P asserts does not exist, is based on a complicated restructuring of the company which occurred in 1988, prior to the VRS acquisition. However, in both cases, these taxes are considered deferred and do not have to be paid unless there is a sale of the assets or a reorganization of certain subsidiaries. Consequently, if VRS were to liquidate RF&P, it would likely be required to pay more than $454 million in federal and State taxes.

It appears that the VRS Board was informed, at the time of the acquisition, of these liabilities and the limitations they posed pertaining to the liquidation of RF&P or the sale of its key assets. The professional advice the Board received supported its plan to hold these assets essentially tax-free for long-term development purposes. While the VRS Board acted prudently based on this advice, some trustees should have pressed their legal counsel for additional, more detailed information.

Based on the tax findings presented in this report, it would be imprudent for VRS to liquidate its interest in the RF&P. If such a liquidation did occur, deferred tax liabilities which can be minimized over time through careful planning will be triggered. Rather than liquidate the company, the consultants retained by JLARC for this study conclude that it would be more beneficial to pursue business strategies which minimize RF&P's tax liabilities and offer the benefit of an enhanced income stream from the company's key assets. This is consistent with RF&P' plans for the management of its assets.

The Investment Value of the RF&P Corporation. Judgments about the value or quality of RF&P as an investment for the

RF&P's Long-Term Deferred Tax Liability Due to Low Basis of Land



Total Liability: $214,273,000

State's pension system must consider the diversity of the RF&P's assets and the Board's purpose in acquiring the company. Although RF&P's assets include valuable, income-producing commercial real estate, the company also owns a substantial amount of undeveloped land. Presently, the most valuable parcels of land produce no capital return, an insignificant amount of real estate income, and are unlikely to experience appreciation in the near future. Consequently, as a short term investment RF&P is unsatisfactory.

However, due to the value of the undeveloped properties, the potential for developing a substantial and steady income stream for the pension fund is strong. Also, it is likely that these properties will experience a considerable amount of capital appreciation in the future. Based on this, the real estate consultants for this study concluded that the RF&P is a reasonable long-term investment for the pension fund.

If the long-term potential of this investment is to be realized, RF&P staff will have to successfully manage the risks associated with this project. This includes the need to negotiate favorable zoning terms for its raw land at Potomac Yard, work out satisfactory agreements with the National Park Service and local officials on infrastructure issues, and keep development costs at a reasonable level.

Oversight and Accountability for VRS' Investment in RF&P

The acquisition of the RF&P Corporation by the Virginia Retirement System represents the merging of two distinctly different organizational cultures. The first is the culture of State government, a large, highly structured, bureaucratic organization with explicit laws, policies, and operational procedures to govern the decisionmaking process and ensure accountability in the expenditure of State resources.

The other, is the culture of a private corporation, the RF&P, which is a 156 year old company, presently experiencing internal shifts in its mission and basic responsibilities. While the RF&P was once a highly structured railroad which owned quality real estate, it is now a real estate company with the sole mission of generating competitive yields for its only shareholder, the State of Virginia. In light of this, important legal, organizational, and corporate governance issues are raised for both VRS and the RF&P.

SHI Could Provide Oversight and Accountability. In 1991, the independent legal counsel for the retirement system recommended that the VRS Board begin using single-purpose corporations to reduce its liability risks associated with its ownership of real estate. Although this recommendation appears unrelated to VRS' subsequent purchase of the RF&P, the Board used changes in the *Code of Virginia* authorizing the use of the corporations to form System Holdings, Inc. (SHI), and granted it the authority to purchase the stock of RF&P.

The mere existence of this holding corporation adds little to the protection from liability that already exists between VRS and RF&P. However, with the current structure of RF&P, SHI should be retained because it serves important governance functions for the VRS. Given the other demands on the Board's time and attention, it is prudent to delegate the initial oversight responsibility to an independent board of directors. Therefore, as long as VRS continues to own the entire equity interest in RF&P as it is now constituted, it should do so indirectly through SHI.

To facilitate proper oversight, SHI should establish a more formal standard reporting format for RF&P that requires the company to provide quarterly reports on the company's investment performance, real estate acquisition program, business plan, fiscal management, and personnel issues.

Recommendation (1). *The board of directors for Systems Holding Incorporated should establish a formal quarterly reporting requirement for RF&P which uses a standard reporting format to oversee the company's performance. This format should request information on RF&P's cash flow including partnership distributions, its real estate acquisition program, a progress report on the status of the business plan, and a report on the company's budget and actual expenditures.*

Coordination of VRS and RF&P Real Estate Acquisitions. As a private real estate company, RF&P has its own real estate acquisition program that will be implemented apart from the activities of VRS' Real Estate Advisory Committee. This situation raises important governance questions related to VRS management of the RF&P asset. As fiduciaries for the pension fund, VRS clearly has the responsibility to expect that its policy views regarding investment decisionmaking be reflected in the investment activities of its real estate managers.

The most effective method to ensure that RF&P's senior management is consistently apprised of the goals and objectives of VRS' real estate program is to place one member of the VRS Real Estate Advisory Committee on the RF&P board of directors. As one of two VRS representatives on the RF&P board, this member could articulate the real estate investment views of VRS to RF&P staff as they consider various acquisitions.

Recommendation (2). *The SHI board of directors should appoint a real estate professional or other qualified member of the VRS Real Estate Advisory Committee to one of the two seats reserved for VRS on the board of directors for RF&P. This member should have a full understanding of and be able to articulate VRS' real estate investment strategy.*

Performance Standards for the RF&P. While RF&P should not be subject to additional external restrictions, both the board of directors and senior management must recognize that the company has a special responsibility to operate in a prudent and efficient manner. Though not a government agency, the company needs to be sensitive to public perceptions and expectations regarding its decisionmaking and operations.

Because of its unique relationship with the Commonwealth of Virginia, RF&P's standard of accountability needs to be higher than the norm for other private corporations. For example, regardless of its performance as an investment for the pension fund, expenditures at RF&P will be especially scrutinized. Every dollar that the company spends will be perceived as money which could have been distributed to the pension fund. In light of this, the RF&P board needs to ensure that public accountability becomes an important part of the organizational culture at the RF&P.

Recommendation (3). *The RF&P board of directors should consider the development of "accountability guidelines" and "standards of conduct" for the board and staff, recognizing the company's unique relationship with the Commonwealth of Virginia.*

Development of RF&P's Business Plan

Since VRS acquired RF&P in 1991, a significant amount of the work of the company has been focused on developing and implementing a business plan designed to make RF&P a cash yielding vehicle for the pension fund. The business plan outlines RF&P's strategy for developing its raw land, resolving various zoning and environmental clean-up issues, and managing the development costs of Potomac Yard. RF&P's

business plan provides a general and conceptual discussion of the company's future plans for minimizing the impact of the taxes on any distributions to the VRS. Basically, the company is in the process of evaluating two approaches. The first would involve the formation of partnerships to develop some of its raw land. The second would involve transforming the RF&P Corporation into a real estate investment trust (REIT).

Based on a review of the work conducted by RF&P staff, the consultants used by JLARC for this study have concluded that the plan is comprehensive, has feasible goals, and can probably be successfully implemented with considerable patience and skill.

Organization and Management of RF&P

Although RF&P appears to have established a sound business strategy for the management of its assets, this plan creates special challenges for the company. In order to execute this plan, both the RF&P board of directors and the company's senior management will have to resolve a number of organizational and management problems within the corporation.

Departments Have Not Adjusted to New Mission. In the new RF&P, each of the company's departments have been redefined to accommodate the corporation's new mission. However, at times RF&P's progress towards fulfilling its new mission has been frustrated by some of the company's tradition-bound employees who have resisted change.

According to most all accounts, none of the major departments within the RF&P — finance, legal, real estate — have completely adjusted to the company's new mission or the demands placed upon them by the president. For a number of reasons, the most serious performance problems appear to have occurred in the Finance Department. Nonetheless, there have also been deficiencies in the performance of the Law and Real Estate Departments.

In some cases, the problems experienced by RF&P are to be expected given the disruptive nature of the attempted merger by CSX and the subsequent acquisition of the company by VRS. Still, in other cases, some staff appear to have been resistant to the new mission and direction of the company.

In addition, attempts by the president of RF&P to reorganize the company around its new mission have been blocked by staff employment contracts which sharply limit any changes in the job functions of virtually all of the company's senior vice-presidents. Based on interviews with RF&P staff, it appears that several of the vice-presidents at the company are either completely or partially underutilized. Given the salaries that the RF&P pays its vice-presidents, this has created special problems in the efficiency of company operations. However, because some of these employees are secured by encumbering employment contracts, a reorganization of the company to address this problem would be costly. If RF&P violates these contracts it must pay the relevant employees amounts that equal two and one-half times their salaries, subject to IRS limits.

Management Style Not Accepted by Staff. When the new management was installed at RF&P in 1991, the company lacked internal operating procedures, had an insufficient number of staff, and was faced with the pressing demand to develop a strategic plan for the management of its assets. So as not to be inhibited by the limitations of existing departments and the railroad-related skills of some staff, the president of the company responded by forming teams to complete specific tasks based on the particular needs of individual projects.

In terms of productivity, the strategy used by the president to organize the work has served RF&P quite well. After a slow start on evaluating its tax questions and developing a strategic plan, the company has developed a business plan, presented it to VRS, and is now prepared to submit a ruling request to the IRS that could eliminate one of its large deferred tax liabilities.

These are important accomplishments for a company that is in the process of being reorganized. However, in accomplishing these objectives the president failed to adequately communicate his management style and objectives to key staff members. As a result, many of the RF&P staff members did not understand his motives for circumventing the hierarchy and have expressed disappointment over what they perceive as an attempt by the president "to push some staff" out of the company. Even staff members who understand and agree with his reasons, suggest that the president's management style has caused some problems, in part, because it was not adequately communicated to staff.

Lack of Attention to Administrative Issues. When RF&P was a railroad, its corporate manual consisted of 43 executive orders which established the operating environment of the company. With VRS' acquisition of the company, six of these executive orders were made obsolete and a decision was made to revise the orders by creating a new corporate policy manual. While revision to the policies were made, they were not adopted by senior management. As a result, a year and a half after the process was initiated, the company has not developed a comprehensive set of policies to establish an operational framework for RF&P and distributed them to staff.

For many employees, this has raised unnecessary questions about the stability of the company. More importantly, it has at times, produced inconsistencies in management practices. Specifically, at the time of this study, RF&P had yet to articulate the company's organizational structure and reporting relationships to all staff members, there was no formal employee evaluation system, company job descriptions were still not ready for dissemination, and there was no policy on moving expenses or staff expenditure authority.

It appears that the primary reason that these organizational issues have not been addressed in a timely manner is the competing responsibilities of the vice-president of Planning and Administration. Although hired primarily to manage the administrative affairs of the company, the vice-president has spent a considerable amount of his time acquiring and closing real estate deals in Northern Virginia and Richmond.

Future Role for RF&P Staff in the Management of the Company's Assets. One question that has been consistently raised about the RF&P Corporation is whether its assets could be adequately managed through a model similar to that used by VRS' real estate division to manage its assets. In this model, VRS' asset managers hire companies to manage the leases on its buildings. When leases expire, the management company is expected to find replacement tenants.

This would not be a prudent approach for the management of RF&P's assets. First, RF&P owns a substantial amount of undeveloped land. Before this land will be converted to a cash yielding asset for VRS, a number of zoning and environmental issues will have to be resolved. This requires a staff that has the knowledge and time to devote to these issues, as well as an ongoing relationship with local officials who control zoning rights.

Second, and perhaps most important, if VRS is to receive an adequate return on this investment, RF&P's deferred tax liabilities must be expertly managed and coordinated with the company's overall plan to generate a tax free yield for the pension fund. Few management companies possess the expertise to deal with the complicated tax questions that RF&P will have to resolve over the next few years.

Interim, Part-Time President Has Created Instability. The current president of RF&P was originally hired by the company's board of directors on a temporary basis to assist in the search for a permanent chief executive officer. In organizing the search process, the board realized that RF&P did not have a clearly defined mission. More importantly, very little attention had been given to how the company would function as a pension fund asset. Consequently, the RF&P board requested that the current president work with the company on an interim, part-time basis to develop a job description for the chief executive officer and a business plan to guide the future direction of the company.

However, at this point, it appears that the company has moved past the stage from which it can further benefit from having a temporary, part-time president. As RF&P moves forward with the implementation of its business plan, the president of the company will be called on a daily basis to address issues related to zoning; commercial and residential real estate development; corporate taxes; real estate acquisitions; real estate finance; and environmental liabilities.

Recommendation (4). *The RF&P board of directors should begin the process to recruit and appoint a permanent, full-time president and chief executive officer for the RF&P.*

Continuity and Political Neutrality Will Be Important for the RF&P Board. As a private real estate company, wholly owned by the Commonwealth of Virginia, RF&P can anticipate a level of interest and scrutiny of its operations that will be unusual for a private corporation. This will be especially true for the policymaking arm of the company — the RF&P board of directors.

As stewards for the RF&P, both SHI and the VRS Board of Trustees need to exercise caution and good judgment in situations whenever it exercises the chief prerogative of a shareholder — the election and removal of board members. If the company is to succeed it is essential that VRS and SHI attempt to establish continuity in service for RF&P directors and work diligently to keep the appointment process free from the appearance of political interference or influence.

Recommendation (5). *The board of directors of System Holdings, Inc. should establish written qualifications for appointments to the RF&P Corporation's board of directors. The criteria for appointment should be based on clearly demonstrated expertise in real estate management, investment, finance, or business management.*

The Future of the Pension Fund's Investment in RF&P

As noted in the discussion of RF&P's real estate portfolio, approximately 43 percent of its assets are undeveloped land. Although this land has considerable value and development potential, there is some risk associated with holding such assets for future development. Under the current structure for this investment, the VRS assumes all of this risk because it owns 100 percent of the company. Should the VRS Board of Trustees determine that such an ownership position is inappropriate for the retirement system over the long term, it should be careful to reduce its interest in the company based on sound economic analysis and in ways which protect VRS' remaining investment in the RF&P.

Regardless of the eventual ownership position which VRS may take in the company, the consultants for this study have concluded that VRS should not find it necessary to provide any financing for the development of the RF&P properties. According to the consultants, RF&P should seek necessary financing from conventional lending sources such as contributions from partnerships or borrowing from commercial banks. It would be imprudent for VRS to finance development in any case for which funding cannot be competitively secured from such conventional sources.

Recommendation (6). *The Virginia Retirement System should evaluate the appropriateness of its sole ownership of the RF&P Corporation. If some reduction of VRS' interest is considered prudent by the Board, it should carefully evaluate alternatives to ensure that the remaining investment in the RF&P Corporation is not jeopardized.*

Recommendation (7). *The Virginia Retirement System should, in keeping with current policy, provide no funding for the development of RF&P land holdings. Financing for the development of the properties should be secured only through conventional sources.*

Table of Contents

COMPANION DOCUMENTS TO THIS REPORT

The research for this study required the combined efforts of JLARC staff and specialized consultants (a listing of consultants is provided on the staff page at end of the report). The consultants' findings are utilized and summarized throughout this report. In addition, two separate companion reports which were prepared by the consultants are available at the JLARC offices:

- *Evaluation of the Virginia Retirement System's Real Estate Investment in the RF&P Corporation*, October 1993, 96 pages.

- *Corporate and Tax Issues in the Acquisition of the Stock of RF&P Corporation by the Virginia Retirement System*, November 1993, 121 pages.

I. Introduction

House Joint Resolution 392 directs the Joint Legislative Audit and Review Commission (JLARC) to study the investment practices of the Virginia Retirement System. A major focus of the study mandate is on the retirement system's investment in the RF&P Corporation. A review of the RF&P investment was of particular interest to the General Assembly because of concerns about the soundness of the investment.

Prior to 1991, RF&P was the oldest railroad company in the United States operating under its original charter. In addition, the company owned substantial land holdings along the Washington, D.C. - Richmond corridor that it had acquired during the railroad's 156 year operating history. In 1990, its principal shareholders were the CSX Railroad Corporation (37 percent), the Commonwealth of Virginia (20 percent), the Norfolk-Southern Railroad Company (six percent), and other individual public shareholders (37 percent).

In May of 1990, the seven-member Board of Trustees for the Virginia Retirement System (VRS) began the process of acquiring the RF&P Corporation through a transaction in which the company's railroad assets were sold to the CSX Corporation. With the completion of a complex series of asset and stock purchases and a tender agreement in October of 1991, the State's retirement system became the owner of the RF&P Corporation, whose primary assets were now real estate.

Although the Virginia Retirement System routinely purchases stock in private corporations, the RF&P investment is considered unique for several reasons. First, by agreeing to purchase all of the company's stock, the Board of Trustees established the pension system as the sole owner of a private corporation. Second, although some of RF&P's properties are income-producing, approximately 30 percent of its gross assets are undeveloped land holdings and must therefore be developed or sold by the company's professional staff in order to generate investment income for the retirement system.

The unique nature of this acquisition has sparked considerable debate and some concern about the retirement system's ownership of RF&P. Critics of this acquisition have voiced serious reservations about the soundness of this investment. Opponents of the acquisition questioned the decision of the Board of Trustees to commit the retirement system to this long-term investment and the potentially high costs associated with the development of RF&P's raw land holdings. Some of those concerned about this acquisition have concluded that the numerous obstacles to large scale development in Northern Virginia and the uncertainty of the commercial real estate market make this the riskiest investment in the pension fund portfolio.

Supporters of the RF&P investment offer a different view. They contend that RF&P's $660 million in gross assets — including an approximately $100 million cash reserve — and the company's ownership of one of the most valuable pieces of undeveloped land in a major metropolitan area, make this acquisition one of the best and least risky investments in the pension fund's portfolio.

The concerns and debate about the investment were due, in part, to a lack of information about the acquisition available to the General Assembly. While there is no requirement for VRS to inform the General Assembly of its intent for each individual investment it may consider, the unique nature of the RF&P investment and the General Assembly's ultimate constitutional responsibility for the retirement system should have prompted the VRS to better inform the Legislature of the purpose and long-term benefits of the acquisition.

This report presents the results from JLARC's analysis of the RF&P investment. As a part of this review, JLARC examined the decisionmaking process used by the Board of Trustees when making the investment. In addition, JLARC procured the services of a team of professionals knowledgeable in real estate development, financial accounting, and corporate tax law to help assess the soundness of the State's investment in RF&P. As a part of this evaluation, the consultants examined the company's business plan for managing its assets, including both the income-producing properties and the undeveloped parcels of land.

THE HISTORY OF VIRGINIA'S INTEREST IN THE RF&P CORPORATION

Prior to VRS' decision to purchase the RF&P Corporation in 1991, the State's economic interest in the company predated the Civil War. On February 25, 1834, the General Assembly granted RF&P a charter to operate a rail line from Richmond to the Potomac River. In addition to giving RF&P the right to establish and operate the rail line, the charter vested all of the profits from the railroad to shareholders and provided a special tax exemption for income created from this investment. Moreover, in an effort to encourage initial capital investment in RF&P, the General Assembly placed language in the charter which prohibited, for thirty years, the construction of any other railroad along this corridor.

The establishment of this special charter for the RF&P was a part of a larger State initiative to foster economic development in Virginia by encouraging the private development of more sophisticated transportation systems. For a variety of public works projects — canals, toll bridges — the State agreed to purchase 40 percent of the capital stock on the condition that the public had already acquired the first 60 percent.

The 1834 charter for RF&P authorized capital stock at $100 per share up to the amount of $700,000 or 7,000 shares. One year after the charter was established, the General Assembly authorized the purchase of 40 percent of RF&P's stock and subsequently acquired 2,752 shares.

State-Owned RF&P Shares Increased Due to Stock Splits and Dividends

After the State purchased its original 2,752 shares of RF&P stock in 1835, RF&P first implemented a series of declared dividends and later two stock splits which considerably increased the number of shares owned by the State. A stock dividend is a distribution of the company's stock to shareholders on a proportional basis. For example, if a company announces a 10 percent dividend and a shareholder owns 100 shares of stock, the investor would receive an additional 10 shares (.10 x 100).

A stock split occurs when a corporation increases the number of its common shares and proportionally decreases their par value. For example, if a firm's stock has a par value of $100 per share and the company announces a 4 for 1 stock split, the par value will drop to $25. If, under these circumstances, a shareholder owned 100 shares prior to the split, the number of shares owned after the stock split would increase to 400.

Purpose of Stock Dividend. When a company issues a stock dividend, the fair market value of the dividend is subtracted from the company's retained earnings and credited to its common stock account. This is done to reflect the fact that no cash is being disbursed to shareholders. This method of capitalizing retained earnings increases the shareholder's equity in the company without depleting the company's cash reserves. As was the case with RF&P, this strategy is often used by firms that are experiencing growth and in need of cash to finance expansion.

Purpose of Stock Splits. The principal effect of a stock split is to lower the per share market price of a company's stock. As with stock dividends, the net equity of the company issuing the dividend does not change. This strategy is used by profitable companies with high stock prices as a means of making its stock more attractive and accessible to a larger pool of potential investors.

As Figure 1 illustrates, before the General Assembly transferred the State's shares of RF&P stock from the general fund to the VRS in 1991, declared dividends and stock splits increased the number of shares owned by the State from 2,752 in 1835 to 3,509,600 — an increase of more than 1,200 percent. A substantial portion of this increase was created by a 50 to 1 split in 1988. Based on the price offered to the public for its shares of RF&P stock in 1991 of $39 and unadjusted for inflation, the State's initial investment in 1835 of $275,200 had grown to $136,874,400 over this 156 year period.

The General Assembly Transfers RF&P Stock to VRS but Retains Control

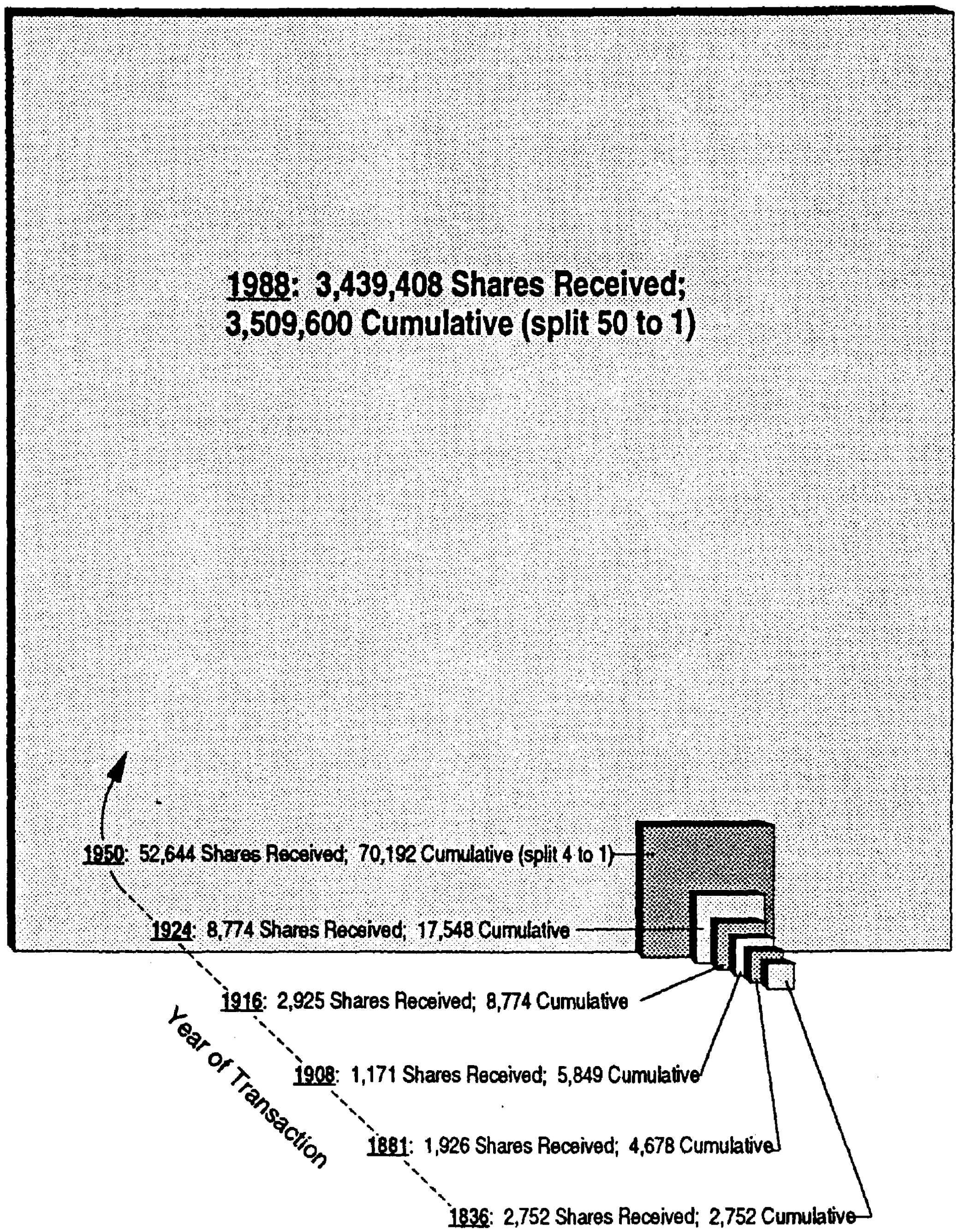
After the General Assembly purchased an interest in the RF&P Corporation, all of the shares of RF&P stock were held in the State Treasury. As the following language from the Acts of Assembly indicate, the benefits of stock ownership for these shares would accrue to the State's general fund.

> All dividends or other sums received on account of the interests in or stock in or claims of the Commonwealth against the Richmond, Fredericksburg and Potomac Railroad Company shall be paid to the general fund of the State Treasury.

However, in 1970 the General Assembly decided to transfer the shares of RF&P stock from the State Treasury to the pension fund. This was done to make additional funds available for the State budget. In addition, the retirement system in Virginia, like

Figure 1

Growth in the RF&P Shares of the State of Virginia 1836 to Present



Source: Auditor of Public Accounts.

those in a number of states, was substantially underfunded. According to an actuarial analysis conducted for VRS in 1970, the assets of the pension fund were sufficient to meet only 63 percent of the fund's accrued liabilities.

While an unfunded liability in any particular year does not mean that a pension fund is insolvent, steady growth in this liability over time will increase the State contribution rates necessary to maintain the soundness of the system. The transfer of RF&P stock from the State Treasury to VRS was made in lieu of the State's cash contribution to VRS in 1970 and was viewed as one mechanism for bolstering the assets of Virginia's pension fund. It also made needed cash available for the State budget.

Stock Transfers Between the General Fund and VRS. At the time of the stock transfer to VRS , the number of RF&P shares owned by the State had increased from 2,752 to 70,192. As a part of implementing this transfer, the General Assembly set the value of these shares at $8,660,600 ($123 per share) but placed one important restriction on VRS' use of the stock. Specifically, VRS could not sell, pledge, encumber, or otherwise dispose of the stock without the consent of the General Assembly. In addition to this restriction, Section 2.1-187 of the *Code of Virginia* required that the stock be subject to re-transfer to the State Treasurer upon payment to VRS of the stated value.

In effect, this provision of the *Code of Virginia* enabled the General Assembly, in later years, to order a series of stock transfers between VRS and the general fund. Through language placed in the Appropriations Act, VRS was required to sell the RF&P stock it held to the State Treasury at the price which the shares were carried on VRS' books. VRS would then be required to repurchase the stock from the State Treasury at a higher market value, usually based on its publicly traded price. The revenue generated from these stock transfers was then used by the Governor and the General Assembly to meet a portion of the funding requirements of the State's overall budget.

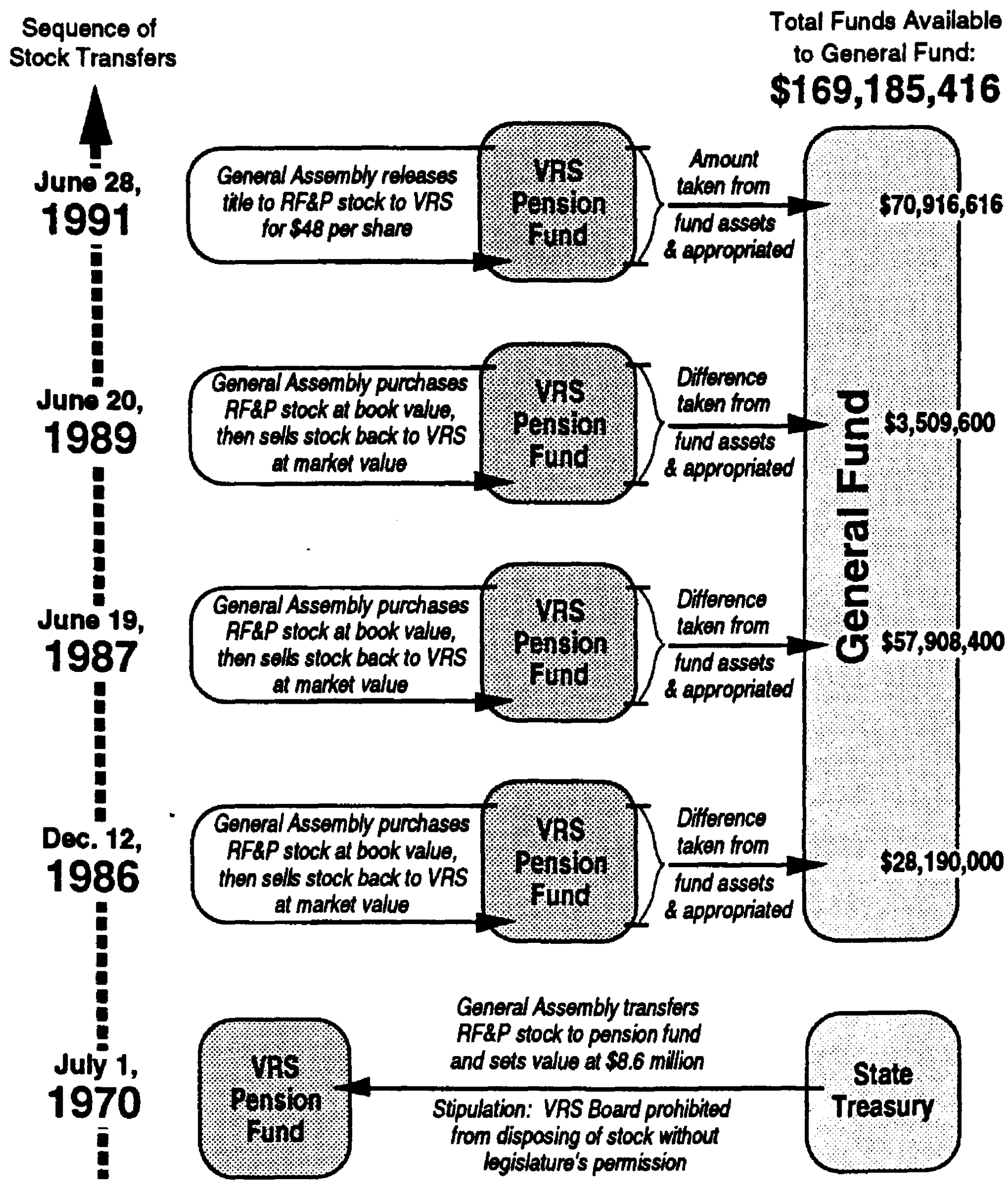
As Figure 2 illustrates, the stock transfers were conducted on four separate occasions. When added to the initial value of $8.6 million placed on the stock by the General Assembly in 1970, these transactions made available a total of $169 million in additional funds for appropriation in the State budget. With the last transaction in June of 1991, VRS gained clear title to the RF&P stock from the General Assembly. One of the questions which surrounds VRS' acquisition of the RF&P Corporation is how the funds spent by VRS to facilitate the stock transfers should be accounted for when determining the actual price the Board of Trustees paid to acquire the RF&P Corporation.

THE RELATIONSHIP BETWEEN THE CSX CORPORATION AND RF&P

Before the VRS Board of Trustees acquired RF&P in 1991, a primary shareholder in the company was the CSX Corporation. CSX was formed in 1980 through a merger of Chessie System, Inc. and Seaboard Coast Line Industries. Since the merger, CSX has grown into a Fortune 500 international transportation corporation with considerable interests in trucking, warehouse distribution, ocean container shipping, undeveloped real estate, and large vacation resorts.

Figure 2

The RF&P Stock Transfers Between the Virginia Retirement System and the State General Fund



Source: JLARC graphic based on information from the Virginia Retirement System and the Auditor of Public Accounts.

In addition to considerably expanding the size of CSX, the merger linked the company to RF&P in two ways. First, prior to the merger, the Chessie System was an 11,000 mile railroad which operated primarily in the Midwest and Mid-Atlantic regions of the United States. Seaboard Coast Line was also a railroad company with more than 16,000 miles of track primarily in the South, Mid-Atlantic, and Midwest regions of the country.

RF&P was important to both of these companies because it owned a rail classification facility at Potomac Yard which served as a connector for the two railroads. Seaboard Coast Line owned rail lines in Southern Virginia and relied on RF&P's 113 miles of track and its large switching station at Potomac Yard to make a connection with the Chessie System rail lines in Northern Virginia. Therefore, through the merger of the Chessie System and Seaboard Coast Line, CSX was established with an extensive rail system that was serviced in part by RF&P.

The second linkage between CSX and RF&P that was created by the merger relates to the actual ownership of RF&P stock. Prior to their merger, the Chessie System and Seaboard Coast Line each owned 12 percent of the existing shares of RF&P stock. In addition, these companies also owned 80 percent of the Richmond-Washington Company which owned 12 percent of RF&P's stock (Figure 3).

By acquiring, through the merger, the RF&P shares owned by the Chessie System and Seaboard Coast Line, and by obtaining control of the Richmond-Washington Company, CSX became the largest individual shareholder in the company, controlling 37 percent of RF&P's stock. In addition, CSX also controlled more than half of RF&P's common or voting stock. Through control of RF&P's common stock, CSX subsequently gained control of six of 12 seats on the RF&P board of directors.

The State, with the shares that it purchased in 1835, owned the second largest block of RF&P shares — approximately 20 percent. Norfolk-Southern Railroad held six percent of the company's stock. All other shares were held by individual public shareholders.

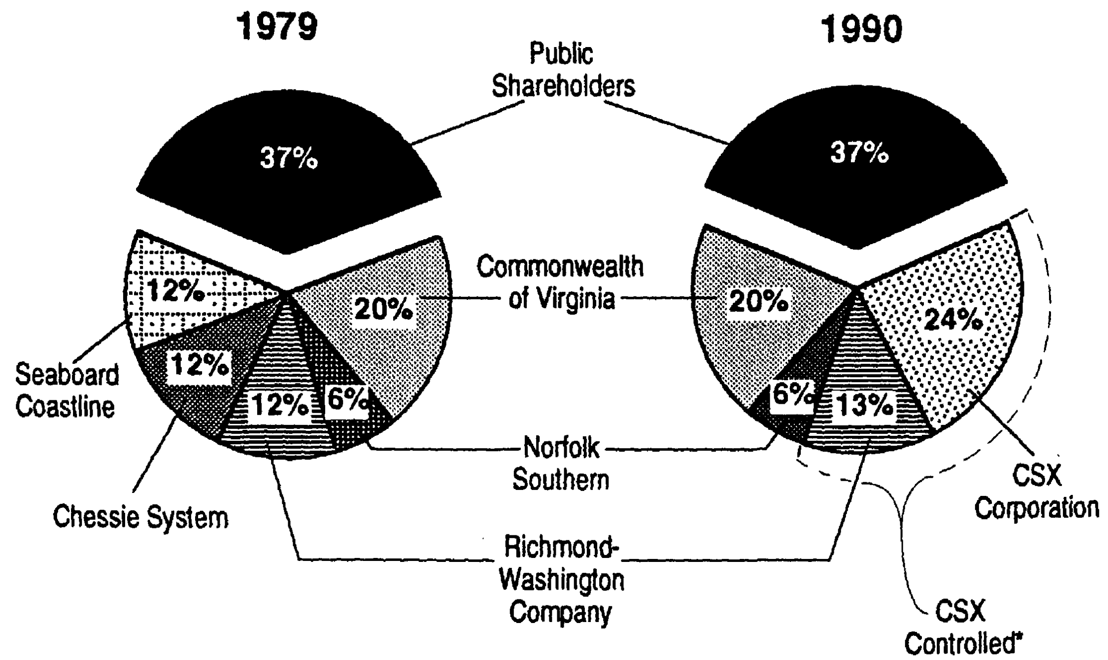
CSX Attempts to Merge With RF&P

Motivated by the close business relationship that its 1980 merger created with RF&P, CSX worked with a Special Committee of the RF&P Board of Directors to consider ways of combining the State's two largest railroads. From the perspective of CSX, the existence of a separate railroad between its two major rail lines created operational inefficiencies because it could not control the costs of connecting its two rail systems.

At the same time, RF&P was now almost completely dependent on CSX for its operating revenue because of CSX rail traffic on the company's track. For example, in 1989, 85 percent of RF&P's gross revenue was generated by allowing CSX access to its rail services.

Figure 3

Changes in the RF&P Corporation's Ownership Structure



*Because it owned 80% of Richmond-Washington, CSX actually controlled 37% of RF&P shares after the merger.

Source: JLARC staff analysis of RF&P Corporation stock information.

Based on this relationship, management at CSX and the RF&P Special Committee considered several strategies for merging the two companies. Among the proposals discussed but eventually rejected were the following:

- CSX would purchase the railroad assets of RF&P, excluding the Potomac Yard and other non-rail assets, for $90 million.

- RF&P would lease its railroad assets to CSX.

- CSX would give up a portion of the interest (shares) it owned in RF&P in exchange for RF&P's railroad operations. Additionally, certain real estate properties of RF&P would be contributed to a new joint venture between the companies, and RF&P share-holders would be given the opportunity to sell their shares of RF&P stock.

Finally, in February of 1990, CSX and RF&P announced that the two companies had agreed to enter into a complex "definitive merger agreement" which provided for the merger of RF&P into CSX. As a part of the agreement, RF&P shareholders would participate in a "cash election" merger transaction in which each shareholder would receive either $34.50 in cash or one share of CSX stock for each share of RF&P stock they owned.

However, as a part of these transactions, a specified percent of the RF&P shares had to be converted into cash and a certain percent into CSX shares. Specifically, not more than 70 percent and not less than 40 percent of RF&P shares not owned by CSX would be converted into CSX stock. The total consideration for the proposed deal was approximately $385 million.

THE VIRGINIA RETIREMENT SYSTEM'S ACQUISITION OF RF&P

The complexity of the merger agreement proposed by CSX was heightened by the structure of RF&P's stock and the voting requirements this imposed on shareholders of RF&P. Specifically, RF&P had three classes of stock: common (or voting) stock, dividend obligations, and guaranteed, which consisted of six- and seven-percent series. As a result, the merger agreement could only be approved if at least two-thirds of the shareholders in each class voted in favor of the merger.

Through its 80 percent ownership of the Richmond-Washington Company, CSX controlled the votes needed to approve the merger among the common stock shareholders (Table 1). However, in the other stock classes, CSX had to rely on support from individual public shareholders and the State to generate the necessary two-thirds vote for approval of the merger agreement.

Table 1

Ownership of RF&P Shares Among Different Classes of Stock, 1990

Stockholder	Common Stock	Dividend Obligations	(6%) Guaranteed	(7%) Guaranteed
CSX	--	30.4%		--
Richmond-Washington Company	76.3%	0.3	21.4%	14.8%
VRS	21.1	20.7	--	--
Public Shareholders	2.6	40.9	78.6	85.2
Norfolk-Southern	--	7.7	--	--
Total	100	100	100	100

Note: CSX Corporation owned 80 percent of the Richmond-Washington Company. Norfolk Southern owned the remaining 20 percent.

Source: The RF&P Corporation.

As noted earlier, although the General Assembly transferred the RF&P shares the State owned to VRS to allow any paid dividends to accrue to the pension fund, the legislature still retained control of the stock through statutory restrictions. Specifically, State law required a vote of the General Assembly before the stock could be sold. However, by the time the merger was announced on February 20, 1990 the time period for the introduction of new bills by State legislators during the 1990 session of the General Assembly had expired. Consequently, if this issue were to be addressed in the 1990 session, the Governor would have to introduce the appropriate legislation in either a regular or special session of the General Assembly.

CSX Withdraws Proposal for Merger Agreement

Almost immediately after the proposed agreement was announced, both CSX and the Special Committee of RF&P that approved the merger plan were publicly criticized by several large shareholders and securities analysts. The primary reason for the criticism was the belief that CSX and the Special Committee had undervalued RF&P's real estate assets in estimating the worth of the railroad company.

Particular concern was expressed that the merger agreement would have allowed CSX to acquire RF&P's land and partnership interest in the Crystal City real estate project, as well as 310 acres of prime undeveloped real estate at Potomac Yard. Some investors argued that based on the quality and value of the Crystal City development and the development potential of Potomac Yard, CSX's offer of $34.50 per share did not reflect the true value of RF&P.

Based largely on publicly expressed concern about the proposed merger, the Governor directed the VRS Board of Trustees to conduct an independent review of the plan. The Board was required to present its findings to the Governor prior to a special legislative session which he planned to call in April of 1990 to address this particular issue.

However, on March 23, 1990, one month before the Board could complete its scheduled review of the plan, CSX withdrew its bid for the merger. According to company officials, CSX decided against proceeding with the merger plan because of misinformation which had been presented about the value of RF&P and the small likelihood that the company could receive unanimous support for the deal given changes which had been made to RF&P's board of directors. Following this announcement, CSX officials stated that no new offer involving a higher price for RF&P shares would be made to facilitate the proposed merger.

VRS Board of Trustees Purchase Controlling Interest in RF&P

After the merger agreement proposed by CSX was withdrawn, the seven-member VRS Board of Trustees continued its evaluation of the RF&P Corporation. Finally, after more than 17 months of review and negotiation with CSX, the Board of

Trustees agreed to acquire a controlling interest in the RF&P Corporation, with a transfer of the rail assets to CSX.

As Table 2 indicates, the Board spent the first five months after CSX withdrew its merger proposal, purchasing additional RF&P stock and evaluating the agreement initially proposed by CSX. During the next 11 months, the Board of Trustees negotiated an agreement with CSX and the Special Committee to acquire the stock of the RF&P Corporation.

Additional Stock Purchases. In April of 1990, one month after CSX had withdrawn its merger proposal, the Board's Investment Advisory Committee (IAC) received information that CSX had begun to purchase RF&P stock on the open market. In fact, RF&P records show that CSX purchased 354,900 shares of RF&P stock just two weeks after withdrawing its merger proposal. In an attempt to protect the State's interest should CSX decide to purchase a sufficient amount of shares to control the other classes of RF&P stock, members of the IAC recommended that the Board of Trustees begin purchasing the necessary additional shares of RF&P stock to block this strategy.

In a meeting of the Board of Trustees the following month, the trustees agreed to initiate a series of open market purchases of RF&P stock. Over the next four months, VRS purchased an additional 1.3 million shares of RF&P stock at a cost of $45.2 million. During this time period, the Board of Trustees also received a preliminary report from the company hired to analyze CSX's initial proposal. This report concluded that RF&P's stock was undervalued in the merger plan.

The Nature of VRS' Agreement to Acquire RF&P. In August of 1990, the Board announced that it had purchased additional shares of RF&P stock. Shortly after this announcement, VRS requested a meeting with CSX to discuss plans for acquiring RF&P. After conducting several meetings with CSX and RF&P representatives in August of 1990, the Board of Trustees agreed to a plan to purchase RF&P's real estate holdings. The negotiated agreement was designed to accomplish two major objectives: (1) allow CSX to gain control of RF&P's rail operations so that it could operate its Northern and Southern rail lines more efficiently; and (2) allow VRS to acquire ownership of what was considered some of the State's prime real estate.

Because of the tax implications associated with a complex restructuring of RF&P which took place in 1988, this agreement had to be structured in a way that would allow RF&P's operating railroad assets to be transferred to CSX without altering RF&P's corporate structure. To accomplish this, the acquisition was structured and implemented in the following three stages:

1. *Asset Purchase Agreement.* This agreement required RF&P to provide CSX with all of its railroad assets and liabilities in exchange for the 3.8 million RF&P dividend obligations it owned. Each of these dividend obligations were valued at $35 per share for a gross consideration of $135 million.

2. *Stock Purchase Agreement.* This was an agreement between CSX, VRS, and CSX's affiliate — the Richmond-Washington Company. This agreement

Table 2

The Virginia Retirement System's Acquisition of RF&P: A Purchase Chronology

Date	Event	Outcome
March 14, 1990	VRS Board and its investment Advisory Committee (IAC) hire a firm to evaluate the CSX proposed merger agreement	The Mark Boyar Company is hired
March 20, 1990	CSX Corporation requests that its proposed merger agreement with RF&P be terminated	Special Committee of RF&P terminates agreement on March 23, 1990
April 1-23, 1990	CSX initiates purchase offer for additional RF&P shares	CSX purchases 354,900 additional RF&P shares
April 30, 1990	The IAC agrees to recommend that the Board of Trustees purchase additional shares of RF&P stock to strengthen the State's interest and position in the company	IAC approves recommendation to Board of Trustees
May 10, 1990	The Board of Trustees accepts the IAC recommendation to purchase additional RF&P stock	Board initiates purchase of additional RF&P stock
May 17, 1990	The Mark Boyar Company reports to the Board that RF&P's stock was substantially undervalued by the CSX proposal to merge the companies	No action taken
August 7, 1990	The Board of Trustees completes its open market purchase of RF&P stock and meeting is scheduled with CSX	Board now owns 28 percent of RF&P stock and holds a meeting with CSX to discuss RF&P merger plans
September 14, 1990	The Board of Trustees announces that it has proposed to acquire a controlling interest in the RF&P Corporation after spinning off all of its railroad assets to CSX	Proposal submitted to RF&P Corporation
June 18, 1991	The Special Committee of RF&P recommends approval of a revised version of Board's proposal	Revised proposal submitted to VRS Board of Trustees
August 28, 1991	Board of Trustees adopts resolutions creating a holding company and gives it the authority to execute the agreement required to acquire RF&P's real estate assets	The Virginia Retirement System's holding company executes an asset purchase, stock purchase, and tender agreement to acquire the RF&P Corporation

Source: JLARC staff analysis of documents from the Virginia Retirement System and the RF&P Corporation.

required the Richmond-Washington Company to sell the 2.9 million shares of RF&P stock that it owned to VRS at a price of $35 per share for 80 percent of the stock and $39 per share for the remaining 20 percent. The total cost to VRS for this transaction was $106 million.

3. *Tender Agreement*. In this agreement VRS consented to pay $39 per share to all outstanding public shareholders who wished to sell their RF&P stock. Since practically all of the public shareholders agreed to sell their shares to VRS, the total cost of this tender offer was $228 million.

When added to the cost VRS paid for the block of RF&P stock owned by Norfolk Southern in 1990, the total cost of these transactions was $379.6 million. After the execution of the asset purchase agreement, stock purchase agreement, and tender offer were completed, RF&P was transformed from a railroad company with substantial real estate holdings, to a real estate corporation with no significant operating railroad assets.

Board of Trustees Uses a Holding Company to Oversee RF&P Investment

As shown in Table 2, the Board of Trustees created a subsidiary corporation called System Holdings Incorporated (SHI) to execute the three agreements for this acquisition. Often referred to as single-purpose corporations, these companies are usually set up to "hold" the majority of stock in a company so that it may control that company's operations.

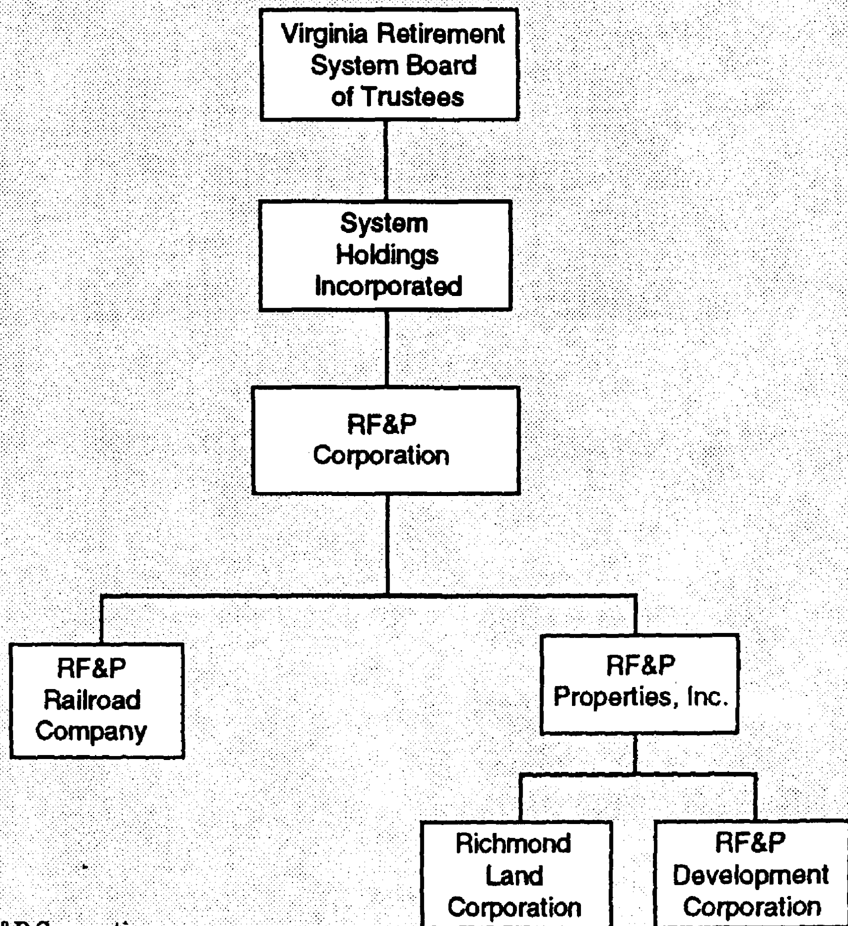
VRS uses holding companies to protect the assets of the pension fund in the event that any of the real estate properties it has purchased becomes the basis for a lawsuit. Because the holding companies own these real estate assets and manage the properties, a "corporate veil" or shield is created which legally separates VRS and the assets of the pension fund from the real estate assets.

Presently, all of the stock in the RF&P Corporation is held by SHI which is wholly owned by VRS (Figure 4). The board of directors for RF&P remains the policy making arm of the corporation and RF&P management and professional staff are primarily responsible for carrying out board policies.

It is through the board of directors for SHI that the VRS Board of Trustees is able to both oversee and exert some influence on the operations of RF&P. It is important to note, however, that there are some limits to the restrictions that parent companies such as VRS can place on its subsidiary corporations such as SHI. Therefore, a key issue for this study is whether the use of a holding company is the most appropriate organizational structure for VRS in managing its investment in the RF&P Corporation.

Figure 4

Organizational Structure of System Holdings Incorporated and the RFP Corporation Within the Virginia Retirement System



Source: RF&P Corporation.

RF&P'S MAJOR DEVELOPMENTS AND LAND HOLDINGS

Presently, the RF&P Corporation has a unique range of assets valued by the company at more than $660 million. These assets include more than 5,000 acres of land with development projects providing approximately 9 million square feet of space. Virtually all of the company's land holdings and buildings are located between Richmond and Washington, D.C.

In general, RF&P's assets can be divided into two distinct classes — operating assets and raw land. Further, within each of these asset classes there is some diversity in the nature of both the operating or incoming-producing properties and the raw land holdings.

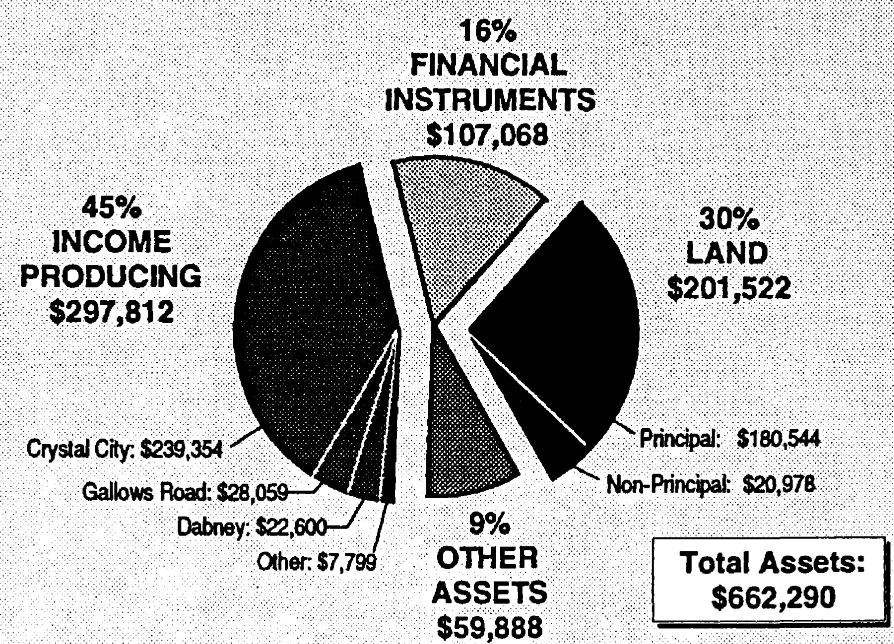
Specifically, 45 percent of RF&P's assets are considered operating and income-producing (Figure 5). These are major properties which are developed and currently producing a cash yield for RF&P. Most of the company's income-producing assets (approximately 80 percent) were developed as a part of a major commercial real estate project in Crystal City. Other properties in this asset class include office and light industrial properties in Richmond, and small commercial office space in Tyson's Corner.

The second group of assets are classified by the company as undeveloped land holdings. As Figure 5 illustrates, 30 percent of the company's gross assets fit this category. According to management at RF&P, within this asset class, it is important to distinguish between the company's principal and non-principal land holdings. Principal land holdings are those which can be developed as a cash yielding asset under a plan that is reasonable for a pension system such as VRS. Currently, company officials consider approximately 80 percent of RF&P's raw land holdings to be principal assets, most of which is represented by the Potomac Yard in Arlington and Alexandria.

Conversely, non-principal land holdings are those which for a number of reasons, cannot be viewed as an appropriate asset for a pension fund. According to RF&P staff, this surplus land will probably be sold if the company receives acceptable offers.

Figure 5

Total Assets of the RF&P Corporation
(Dollars in Thousands)



Source: RF&P Corporation's unaudited financial statements, December 31, 1992.

Crystal City Is RF&P's Primary Income-Producing Asset

The cornerstone of RF&P's operating properties is the Crystal City development which is located in Northern Virginia on the perimeter of Washington, D.C. RF&P land holdings in Crystal City consist of approximately 74 acres that it acquired during the 1950s.

In 1963, the company began to lease this land for development purposes to the Charles E. Smith Development Company. Thirty years later, through partnerships with this company, RF&P had acquired interests in the following major developments in Crystal City:

- *Crystal Park.* This is the largest development in Crystal City. It contains 2.1 million square feet of space containing 5 office buildings and 540 apartments. RF&P participates in 50 percent of the profits from this development.

- *Crystal Square.* This project contains 1.4 million square feet of development consisting of office space, apartments, and retail shops. RF&P receives 50 percent of the profits from this project.

- *Crystal Plaza.* This project contains 1.2 million square feet of office space, apartments, and 45 stores. RF&P's interest is only five percent because of the small amount of land held in the project.

- *Crystal Mall.* This commercial development consists of office space and a 340 room hotel. RF&P receives 50 percent of the profits.

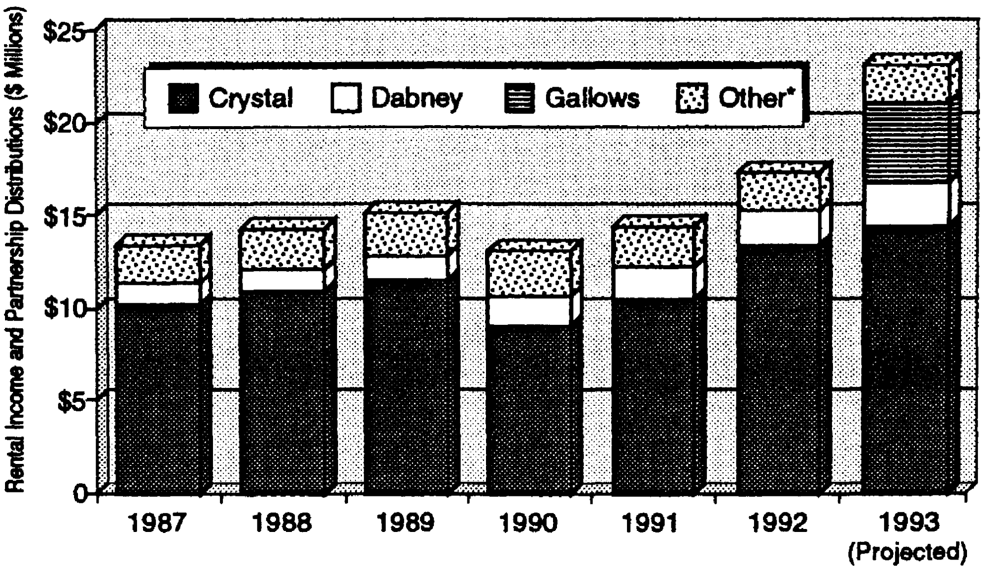
Largely as a result of this partnership, Crystal City is the most valuable income-producing asset in which RF&P has an interest. Since 1987, this real estate project has consistently accounted for more than two-thirds of the company's income from its real estate projects (Figure 6). For example, in 1987, the company's income from rent and partnerships was approximately $13 million. Crystal City accounted for more than 76 percent of this income. In 1992, RF&P's operating income surpassed $17 million and Crystal City was responsible for approximately $13.5 million.

RF&P's other income-producing properties are Gallows Road and the Dabney Center. Gallows Road, which is valued at $28 million is located at Tyson's Corner. This building consists of more than 225,000 square feet of commercial office space and it sits on four acres of land.

The Dabney Center, located in Richmond, also provides commercial office space. RF&P purchased the 50 acres of land on which this company sits in the 1920s. Construction on the Dabney Center, which is presently valued at $22 million, was begun in 1981. The company anticipates building an additional 76,000 square feet on this land in the near future. RF&P has also leased the newly-acquired Price Club property, located near the Dabney Center.

Figure 6

The RF&P Corporation's Rental Income and Partnership Distributions, 1987-1993



*Other indicates other light industrial properties.

Source: The RF&P Corporation.

Potomac Yard Is the Focus of RF&P's Future Development Plans

Although RF&P owns more than 2,600 acres of undeveloped principal land, the primary focus of the company's development plans over the next decade will be on Potomac Yard. In acres, this site constitutes only 12 percent of RF&P's undeveloped principal land holdings, but it represents more than 80 percent of the total value of RF&P's principal raw land. More importantly, it was the estimated cash yielding potential of this asset which led some analysts to conclude that the CSX attempted buyout of RF&P shareholders, at $34.50 per share, substantially undervalued the assets of RF&P.

The land on which Potomac Yard is located was purchased by RF&P in the early 1900s and now sits partially in both the City of Alexandria and Arlington County. As noted earlier, when it operated as a railroad, RF&P used Potomac Yard as a rail classification facility and provided services for railroads operating along the East Coast. Presently, Potomac Yard is still used as a switching station on a limited basis, but RF&P plans to close the facility in 1994.

Before VRS acquired the company, RF&P initially planned to use a portion of the 310 plus acres in a joint venture with CSX to plan a development for Potomac Yard. Known as Alexandria 2020, this community would have included townhouses, apartments, condominiums, commercial office space, retail shops, and hotels. However, as a part of the VRS agreement to acquire RF&P's real estate, this joint venture was terminated. RF&P paid CSX $480,000 for the costs CSX incurred in planning this joint venture and continued to pursue development of Alexandria 2020.

Throughout the planning stage for this project, there has been considerable disagreement between officials of Alexandria, Arlington, the National Park Service (NPS), the Metropolitan Washington Airports Authority (MWAA), and RF&P concerning a number of issues. Some of the key questions which these officials and RF&P management had to address were as follows:

- Should development on Potomac Greens — a site adjacent to Potomac Yard — be exclusively residential?

- Should total development on Potomac Yard and Potomac Greens be limited to six million as opposed to 14.5 million square feet?

- Should a minimum of 80 percent of the total development space be allocated for less profitable residential units?

- Should the developers be responsible for all of the infrastructure costs including the building of a Metro Station?

- Should prospective residents of Potomac Greens be given access from the development to the George Washington Parkway under a plan previously approved by the NPS?

- How much compensation should RF&P receive from the Airports Authority for limiting developmental rights on a portion of the Arlington Industrial Area (AIA).

In 1990, RF&P published a concept plan which specifically addressed most of the aforementioned questions. When the Alexandria City Council rejected key portions of the plan, Alexandria 2020 was eventually terminated. Since that time, RF&P has won a court decision affirming certain development rights for the company on Potomac Greens.

However, still to be resolved are issues involving access to the federally-owned George Washington Parkway and the amount of compensation that RF&P should receive for the portion of its land that is effectively condemned by the Airports Authority. Presently RF&P staff are working with local officials in Alexandria and Arlington, NPS administrators, and officials from the MWAA on these issues.

Obviously, a key to whether the State's investment in RF&P can be regarded as sound greatly depends on the outcome of these current negotiations. Therefore, one of the objectives of this study is to evaluate both the progress and likely success RF&P may have in attempts to resolve some of the development and land use issues related to Potomac Yard.

STUDY MANDATE

In 1993, the Virginia General Assembly passed House Joint Resolution 392 (Appendix A). This resolution directs the Joint Legislative Audit and Review Commission (JLARC) to study the investment practices of VRS, giving special attention to the Board of Trustees' acquisition of RF&P.

Since the acquisition, questions have surfaced about the decisionmaking process used by the Board of Trustees in acquiring the RF&P Corporation, the soundness of this investment, and whether the demands of public accountability can be effectively addressed in the operational framework which the VRS Board of Trustees has established for RF&P. The mandate for this study requires JLARC to examine the decisionmaking process associated with this particular investment, assess whether the decision to purchase this company was financially sound, and determine the most appropriate structure for the continuous ownership of RF&P.

STUDY APPROACH

The JLARC review of RF&P was broadly designed to address three major concerns related to the investment in RF&P: (1) did the Board properly discharge its fiduciary responsibility when making the decision to acquire the company; (2) is RF&P a prudent and sound investment for a public pension fund like VRS; and (3) is the use of a holding company the most appropriate mechanism to safeguard or manage the State's interest in RF&P.

Based on these concerns, the following research questions were developed:

- Did the VRS Board of Trustees properly exercise its fiduciary responsibility in implementing the process which led to the acquisition of RF&P?
- Given the nature of RF&P's assets, in particular its large amount of undeveloped land, is this a sound investment for the retirement system?
- Does RF&P have a business plan for the long-term management of its assets which will ensure that the pension fund receives a favorable return on its investment?
- Does the RF&P business plan effectively address the complex issues surrounding the operation of a private corporation which has substantial deferred tax liabilities?
- Is the use of a holding company to monitor and provide oversight of RF&P the most appropriate and effective organizational structure for managing this asset?

Because of the complexity and scope of this review, two approaches were used to complete the evaluation. First, JLARC staff examined the investment decisionmaking process that was used by the Board of Trustees over the 18 months in which this investment was studied, as well as the internal organization and management of RF&P.

Second, in light of the special expertise required when evaluating real estate, corporate tax laws, and corporate structure issues, JLARC procured the services of two groups of consultants with experience in these areas to assist the study team in its review. The next section in this chapter provides a general discussion of the main research activities conducted for this study.

Review of the Board's Investment Decisionmaking Process

The key issue regarding the RF&P investment process is whether the Board properly exercised its fiduciary responsibility when evaluating the company as a potential investment opportunity for the retirement system. In examining this process, the study team conducted structured interviews with each member who served on the Board when this decision was made, and collected and reviewed the studies which the Board commissioned as a part of this effort. In addition, both professional advisors to the VRS Board and some members of the Investment Advisory Committee (IAC) were interviewed regarding their roles in this process.

Review of Organization and Management of RF&P

Part of JLARC's evaluation of this investment included a review of and assessment of the organization and management of RF&P. To complete this aspect of the study, JLARC examined the formal organizational structure at RF&P, conducted structured interviews with staff, and examined the company's budget. The structured interviews were used to gather information on a number of topics, with a focus on the process used by management for conducting the work of the company.

Real Estate Consultants Evaluate Soundness of the RF&P Investment

With funds provided by the 1993 General Assembly, JLARC procured the services of two groups of research consultants. The first group was a team of real estate experts with experience conducting appraisals, including site analyses, as well as determining the economic value of real estate. The work of this group was coordinated by the Virginia Real Estate Research Center at Virginia Commonwealth University.

To address the issues related to the soundness of the RF&P investment, the three-member real estate panel was asked to conduct the following activities: a review and assessment of three different sets of real estate appraisals of RF&P; a review of the site analysis performed by the appraisal companies on the undeveloped parcels of RF&P land; a review and analysis of RF&P's business plan; and, an overall assessment of the soundness of VRS' investment in RF&P.

Review of RF&P Real Estate Appraisals. As a part of the investment analysis process that led to the acquisition of the RF&P, three different sets of appraisals were conducted of RF&P's land and property holdings. Therefore, a major research activity of the real estate panel was an analysis of the appraisal work conducted by the three real estate companies. The primary focus of this activity was to determine if the appraisals were of sufficient quality to support the investment decision made by the Board of Trustees.

The Quality of the Site Analysis Work. Because 50 percent of RF&P's assets are undeveloped land holdings, questions have surfaced about whether these parcels can either be sold or developed in a manner that justifies the State's investment in the company. In conducting the appraisal work, one of the most important elements of the process is the site analysis. Properly executed site analyses provide critical information on the highest and best use of undeveloped land, and can be instrumental to determining the short and long-term value of the property.

The real estate panel reviewed and analyzed the site analysis results of RF&P's land holdings that were available to the Board of Trustees during the decisionmaking process. To supplement this data, the panel conducted structured interviews with various local and federal government officials in Northern Virginia. Additional interviews were conducted with municipal officials in localities along the Richmond-Washington corridor. These interviews focused on local zoning restrictions and infrastructure planning for the areas surrounding RF&P's land holdings.

Review of RF&P's Business Plan/Soundness of Investment. Because RF&P owns both income and non income-producing property, there is considerable interest and some concern pertaining to the company's plans for managing and developing its large land holdings. At the center of these concerns is uncertainty about how the company intends to turn the undeveloped land into a profitable yield for the pension fund.

To help address these concerns the real estate panel reviewed and analyzed RF&P's business plan. Focusing on the specifics of RF&P's development plans such as financing strategies, cash yield projections for the pension fund, and management of local zoning issues, the real estate panel evaluated the feasibility of the plan and the potential for its successful implementation.

Tax/Corporate Law Consultants Examined Tax, Accounting, and Organization Issues

The second group of consultants which assisted JLARC staff in this study was a team consisting of tax specialists, two accountants, and a corporate law expert. The members of this team possessed a range of skills relating to corporate tax law, financial reporting in private corporations, and legal issues surrounding the use of various types of corporate structures. Panel members were drawn from the law and business schools of some of the State's major universities.

As a private corporation which operated for 156 years as a railroad, there are a range of tax, accounting, and corporate structure issues that required attention in this assessment of RF&P. To address these issues, the independent panel of tax and corporate law experts were asked to conduct the following activities: evaluate the appropriateness of the single-purpose corporation structure established by VRS to manage its investment in RF&P; verify the nature of all of RF&P's tax liabilities; and evaluate strategies proposed by RF&P staff for minimizing the impact of these liabilities on pension fund assets.

Appropriateness of Subsidiary Corporations. The key issue regarding the use of subsidiary corporations is whether the existing structure established by VRS is sufficient to enable the Board of Trustees to meet its fiduciary obligations with respect to the RF&P investment. In addition, the panel considered the effect of the current structure on the liability risk of VRS in comparison to alternative methods of monitoring its investment interest.

Strategies to Minimize RF&P's Tax Liability. As discussed earlier, when examining the investment options and earnings potential of RF&P, serious consideration must be given to the effect of any strategy on the company's tax status and its deferred liabilities. As a part of analyzing this issue, the panel of experts were required to identify the source and exact amount of RF&P's deferred tax liabilities. In addition, this panel assessed the soundness of RF&P's proposed plan to generate a cash yield for the retirement system without triggering its liabilities.

REPORT ORGANIZATION

The two remaining chapters in this report provide an assessment of the process used by the Board in making the decision to acquire the RF&P Corporation, evaluate the soundness of the investment decision (Chapter II), and examine some of the key organizational and management issues related to the State's ownership of this corporation (Chapter III).

II. The Soundness of the Retirement System's Investment in the RF&P

Although the price the Board of Trustees paid to purchase RF&P presently accounts for less than three percent of the total assets of the pension fund, this acquisition represents the largest and most complex single real estate investment which VRS has ever made. Partly as a result of this, concerns have been raised about the quality of the investment, whether the VRS Board of Trustees obtained the necessary professional advice when it acquired the RF&P, and whether the decision to acquire the RF&P was reasonable given the information available to the Board.

The findings from this study indicate that while some VRS Board members should have been more aggressive in questioning its professional advisors about the full implications of RF&P's tax liabilities, it appears that the trustees did seek and have available appropriate professional advice. In addition, the trustees appear to have acted reasonably, and properly exercised their fiduciary responsibility, in acquiring sole ownership of the company.

A determination of the quality of this investment is complicated by the nature of RF&P's assets which include a large amount of undeveloped raw land, as well as an interest in valuable income-producing properties in Crystal City. RF&P's investment income from the Crystal City properties is substantially greater than the returns from other real estate assets in VRS portfolio. However, because RF&P's principal raw land holdings do not generate significant investment income in the short term, as a group, the company's assets under-perform the other real estate properties in VRS' portfolio.

Still, members of the VRS Board of Trustees point out that the RF&P was not purchased as a short-term investment. Rather, the chief reason for the investment was to acquire for the pension fund an interest in the future commercial and residential development of the valuable 310 acre site at Potomac Yard. From an economic standpoint, when the potential income from such a project is considered along with the existing value of the Crystal City properties, the acquisition of RF&P is viewed by the consultants hired to assist JLARC in this study as a prudent long-term investment for the Virginia Retirement System. Realization of an appropriate return will, however, require time and careful planning. Further, prompt liquidation of the properties is not recommended because of the RF&P's substantial tax liabilities.

Whether this long-term development potential is fully realized will be determined in part by the success of RF&P staff in overcoming the inherent risks associated with large scale development projects. Paramount among these risks for RF&P is the uncertainty of environmental clean-up costs for the Potomac Yard. Other risks include local and federal opposition to some aspects of RF&P's tentative development plans in Northern Virginia and the uncertain but likely high costs of infrastructure development.

This chapter presents the results from JLARC's review of VRS' acquisition of the RF&P and the JLARC consultants' analysis of the soundness of this investment. The consultants' detailed reports supporting the findings presented in this study are available on request. Included in this chapter is a review of the factors considered by the VRS Board in its acquisition of the RF&P, an analysis of the cost of the acquisition to VRS, an evaluation of RF&P's tax liabilities, and an assessment of the value of the RF&P investment.

REASONABLENESS OF THE ACQUISITION OF RF&P BY VRS

As trustees for the Virginia Retirement System, the VRS Board has a legally binding fiduciary duty to protect pension fund assets by exercising the necessary prudence and skill when considering any investment. Given this responsibility, the nature and structure of the RF&P acquisition imposed special demands on the Board of Trustees. Because the acquisition involved the transfer of railroad assets as payment for RF&P stock, the purchase of a large block of RF&P shares from a holding company, and the purchase of RF&P shares held by public shareholders, the professional and legal advice needed to complete the transaction was substantial.

In general, the information reviewed for this study shows that the Board did properly exercise its fiduciary duties associated with evaluating the RF&P investment before the company was acquired. In evaluating the acquisition, the VRS Board spent $3.8 million to procure the services of special legal counsel, several financial and real estate experts, and a firm specializing in environmental liability studies. Based on the advice the trustees received from these advisors, and the given assessed value of RF&P's assets, the Board acted reasonably in deciding to acquire the company.

State Law Establishes Specific Fiduciary Duties for Board Members

The Virginia Retirement System was created by statute in 1950. Because of the restrictions the General Assembly placed on the use of VRS' assets, the pension fund was essentially organized as a statutory trust. The following language in Section 51.1-102 of the *Code of Virginia* provides the legal basis for the treatment of the VRS pension fund as a statutory trust:

> The assets of the retirement systems administered by the Board are trust funds and shall be used solely for the benefit of members and beneficiaries and to administer the retirement system and shall not be subject to appropriation by the General Assembly.

Common Law Fiduciary Requirements. To facilitate the operation of the fund as a statutory trust, the General Assembly authorized the seven-member Board to serve as fiduciaries with specific duties in overseeing the operation of the pension fund. Further, as members of the VRS Board, each trustee is considered a fiduciary according to common law.

Under common law, VRS Board members have a number of duties that are considered fundamental for guardians of trust funds. In an "Investment Analysis letter" to VRS in 1991, the Board's independent counsel identified these fundamental fiduciary duties for the Board of Trustees. They were as follows:

- *Duty of Loyalty*. Trustees should not operate the pension fund for their personal gain or benefit.

- *Duty to Administer the Trust*. Trustees should exercise the appropriate skill and care to both administer the trust and make investment decisions.

- *Duty Not to Delegate*. Trustees should not delegate matters pertaining to the administration of the trust fund.

- *Duty to Keep and Render Accounts*. Trustees should keep and make available to beneficiaries a clear and accurate account of the pension funds assets.

- *Duty to Take and Keep Control*. Trustees should protect the fund from improper actions by others.

- *Duty to Exercise Care and Skill*. Trustees should use prudence, discretion, and intelligence in the management of the pension fund.

Fiduciary Requirements of VRS Statutes. In separate sections of the *Code of Virginia*, the General Assembly outlines specific duties and fiduciary guidelines solely for the administration of the VRS pension fund. Because these provisions were drafted specifically to govern the operation and management of VRS, they take precedence over some of the principles of common law. If these particular statutes are silent on an issue that relates to the operation of the fund, the Board can then look to common law for the appropriate guidance.

Article 3 of the VRS statutes provides the legal framework to govern the actual investment decisionmaking for the pension fund. As the following provision demonstrates, the General Assembly clearly requires the Board of Trustees to refer to this Article when making its investment decisions:

> Notwithstanding any other provision of law, investment of trust funds by the Board shall be governed exclusively by this article [3].

The Standard of Judgment and Care Required by Law. In addition to a "legal list" of investments which are permitted and prohibited, Article 3 of the VRS statutes, establishes a "Standard of Care" which the Board must exercise when making investment decisions. Using the following language, this provision of the statute outlines the Board's fiduciary responsibilities with respect to investment decisionmaking:

> Except with respect to the securities described in this chapter, in acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of the fund, the Board shall exercise

the judgment of care under circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the safety of their capital . . . .

This provision of the *Code of Virginia* obligates the Board of Trustees to exercise prudence and intelligence by investing the resources of the pension fund in only those assets which can be considered secure and non-speculative. The Board is required to consider the income that will probably be generated by the investment and balance this against the potential risk to capital.

As noted earlier, in 1991, the Board of Trustees procured the services of a law firm to analyze the State statutes concerning its fiduciary duties, particularly as it related to the acquisition of real estate. As a part of this analysis, the Board asked this firm to make recommendations as to how it should carry out its duties in a manner consistent with the requirements of State law. In evaluating the legal requirements of the "Standard of Care," this law firm concluded as follows:

> The Code of Standard of Care requires the Board to act prudently using the skill, discretion, and approach to investment that one would expect in the management of a person's individual affairs . . . . The Code of Standard of Care does not require the members of the Board to act as prudent experts when they invest VRS' funds. To the contrary, it obligates the Board to utilize competent, educated, and trained financial managers if the prudent ordinary man would hire them . . . . The Board is required to seek and manage high quality investments and avoid speculative commercial or industrial real estate ventures.

It is in this context that JLARC staff evaluated whether the Board of Trustees properly exercised its fiduciary duty in evaluating and acquiring the RF&P Corporation. Because of the complex nature of the RF&P transaction and information which has been made public concerning RF&P's tax liabilities, the judgment and amount of care exercised by the Board of Trustees when acquiring this company has been called into question. The next section of this chapter examines the nature of the RF&P acquisition and evaluates how the Board discharged its fiduciary duty in acquiring the company.

Complexity of RF&P Acquisition Imposed Special Demands on VRS Board

As a part of considering the acquisition of a public company, considerable attention must be given to the actual value of the company, applicable federal securities laws and regulations governing such transactions, and the often complex federal and state tax laws which impact the sale or disposition of a company's assets. Under current federal law, the actual purchase of public companies can be accomplished in a number of ways which vary in complexity. These methods include negotiated purchases of individual blocks of company shares, tender offers to public shareholders, and specific asset purchases.

The VRS Board's acquisition of the RF&P was very complex because the goal of the trustees was to acquire the company's stock for its real estate assets while splitting off the operating railroad assets to CSX. As noted earlier, the Board accomplished this by negotiating an agreement that involved three separate but interrelated transactions — a stock purchase agreement, an asset purchase agreement , and a tender offer.

While each of these transactions imposed a specific set of requirements on the VRS Board and its professional advisors, they were negotiated as a package. In this sense, execution of any one of these agreements was conditioned on the implementation of the other two. Table 3 lists the key aspects of these agreements and outlines the basic obligations they placed on the Board of Trustees as fiduciaries for the pension fund. In addition, the specific expertise needed to effectively address the requirements of the transaction is identified.

Requirements of the Asset Purchase Agreement. With asset purchase agreements, the parties involved in the negotiation are permitted to chose which specific assets and liabilities each participant in the transaction will assume. In the case of the RF&P acquisition, this was the vehicle through which RF&P's operating railroad assets were split off from its real estate and sold to CSX. Specifically, VRS proposed to CSX that RF&P transfer its operating railroad assets to CSX in exchange for a portion of the RF&P stock which CSX owned.

In effect, this transaction was a straight redemption of CSX stock which created taxable capital gains for CSX on the sale of its stock. Partly as a result of these tax consequences, this agreement was conditioned on the requirement that VRS initiate a cash buyout (through the stock purchase agreement) of shares of RF&P stock owned by a CSX affiliate.

For a number of reasons, the specific work needed to complete this transaction was both complicated and substantial. First, a decision had to be made concerning which railroad assets would be transferred to CSX and which would remain with RF&P. This decision was complicated by the fact that one of RF&P's key land holdings which was to remain with the company — Potomac Yard — contained railroad assets which would be sold to CSX. Additionally, in order to minimize the payment of certain deferred federal taxes, special consideration had to be given to RF&P's corporate structure when developing this strategy.

Created by a corporate reorganization in 1988, these deferred tax liabilities can be triggered if the structure of certain subsidiary corporations within RF&P are altered through a sale of its stock. Therefore, this agreement had to be executed in a manner that would represent a sale of RF&P railroad's assets and not the subsidiary's stock.

Second, the Board needed advice on which liabilities would be transferred to CSX and other railroad companies which were former tenants of Potomac Yard. In the case of CSX, this included existing liabilities for RF&P's railroad employees such as severance pay. For other railroads such as Norfolk Southern, the most important of these liabilities were environmental, stemming from the possible contamination of the rail

Table 3

Components of the RF&P Acquisition by the Virginia Retirement System

Agreement	Elements of the Agreement	Obligations of Agreement	Expertise Required
Asset Purchase	• RF&P sells its operating railroad assets to CSX	• Negotiation and valuation of RF&P's railroad assets	• Financial analysts/Investment brokers
	• CSX pays for these assets with 3.8 million shares of RF&P stock at $35 per share	• Negotiation and valuation of RF&P shares owned by CSX	• Special legal counsel
	• CSX agrees to assume certain liabilities associated with the operation of railroad	• Transfer of certain liabilities to CSX and other railroads	• Real Estate Appraiser
	• Total consideration = $135 million	• Analysis of tax implications	
		• Interpretation of applicable federal securities laws	
		• Real estate appraisals	
Stock Purchase	• VRS purchases RF&P stock held by a CSX affiliate	• Valuation of RF&P shares held by CSX affiliate	• Financial analysts/Investment brokers
	• Price for 80 percent of these shares set at $35.00	• Interpretation of applicable federal securities laws	• Special legal counsel
	• Price for 20 percent of the shares set at $39.00		
	• Total consideration = $76.6 million		
Tender Offer	• VRS tenders an offer to purchase all outstanding RF&P shares at $39 per share	• Valuation of outstanding RF&P shares	• Financial analysts/Investment brokers
	• Total consideration = $233 million	• Interpretation of applicable federal securities laws	• Special legal counsel
		• Fairness opinion	

Source: JLARC staff analysis.

yard. Because this site was the former switching station for rail traffic along the east cost, it had the potential to pose substantial and costly environmental problems.

Finally, the Board required special expertise to negotiate with CSX on payment for RF&P's railroad assets. Considering that this payment would be the 3.8 million RF&P dividend obligations that CSX owned, some determination had to made as to what these shares were worth relative to the railroad assets for which they were being exchanged.

As Table 3 indicates, the services required to develop asset purchase agreements are typically provided by special legal counsel and brokers or financial analysts at major securities firms. In addition, because the RF&P's primary assets after the transaction would be real estate, this agreement also demanded the skills of a competent real estate appraiser.

Requirements of the Stock Purchase Agreement. As a part of the acquisition, VRS agreed to purchase all of the RF&P stock which was owned by an affiliate of CSX, the Richmond-Washington Company. Unlike the other aspects of the transaction, this agreement was more straightforward. Here VRS had to determine the appropriate price to pay CSX for these shares. In such cases, some analytical work is required of brokers or financial analysts to ensure that the price paid in these agreements is fair to the purchaser.

Requirements of the Tender Offer. The final aspect of the agreement required that VRS propose a self-tender through RF&P for its shares that were held by the public. A tender offer is a special form of a stock purchase which involves an attempt to acquire a substantial amount of stock from public shareholders over a fixed time period. Because a large number of RF&P shares were held by the public (37 percent), VRS needed to initiate a tender offer to gain complete control of the company.

Due in large part to federal disclosure requirements adopted in 1968, tender offers are major legal undertakings requiring a great deal of professional expertise. The key document which the purchaser in a tender offer is required to file with the Federal Securities Exchange Commission is the Schedule 14D-9. This form must identify the purpose of the tender offer, the purchaser, and its source of funds to finance the transaction. In addition, the schedule provides a detailed discussion of any negotiations between the purchaser and the company whose publicly-held shares are being acquired.

A primary consideration of the purchaser in any tender offer is whether the price that it is paying for publicly-held shares of stock is fair. These questions are typically answered in fairness opinions by financial advisors. While never straightforward, the fairness opinion VRS needed in this transaction was complicated by the fact that the tender offer price had to be considered in light of previous transactions. Most notably, the opinion needed to consider the prices which VRS had already paid to purchase a large block of RF&P stock on the open market and to execute the asset and stock purchase agreements.

Nature of Professional Advice Sought by VRS Board Appears Appropriate

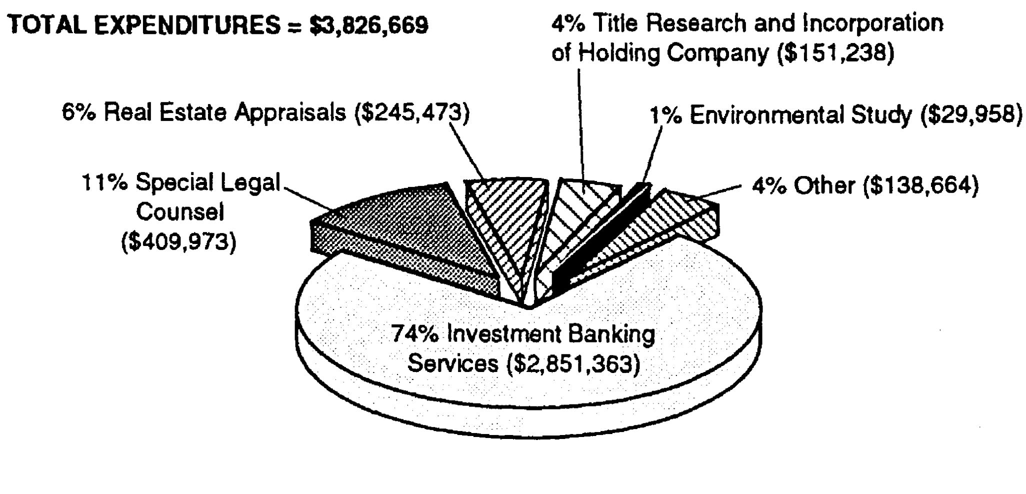
Based on a review of the documents from VRS and interviews with the trustees, it appears the Board did hire the professional advisors required for a transaction of this nature. In total, the Board spent more than $3.8 million to secure the services of an investment banker, special legal counsel, real estate appraisers, and environmental experts.

Investment Banking Services. As illustrated in Figure 7, the majority of the $3.8 million (74 percent) spent during the acquisition process were paid in fees to the nationally recognized investment banking company of PaineWebber. Traditionally, investment bankers play an integral role in public mergers and acquisitions.

According to interviews with a former employee of PaineWebber, members of the VRS Board of Trustees, and a review of documents related to acquisition, PaineWebber provided assistance in three key areas of the RF&P transaction: (1) development of the framework to facilitate the splitting off of the railroad assets to CSX and the purchase of RF&P stock for the remaining real estate assets; (2) negotiation of key aspects of the transactions including the price which VRS should pay to various shareholders to consummate the acquisition; and (3) development of a fairness opinion to indicate whether the price VRS paid the public shareholders was fair given the other aspects of the acquisition.

Figure 7

Professional Services Procured by VRS During the Acquisition of the RF&P Corporation



Note: Financial records from VRS indicate that RF&P paid $3.4 million of the total expenses processed by VRS during the acquisition of RF&P. These figures have been rounded and may not precisely match those reported by VRS.

Source: Virginia Retirement System.

Special Legal Counsel. Approximately 11 percent of the funds spent to evaluate this deal were used to procure the services of legal counsel specializing in mergers and acquisitions. A broad range of legal services were required in this transaction. Especially important were the negotiations and subsequent document preparation to accommodate the demands of the asset purchase and stock purchase agreements as well the VRS tender offer. The following progress report from one of the law firms that performed some of the legal work illustrates the required scope and nature of the legal services:

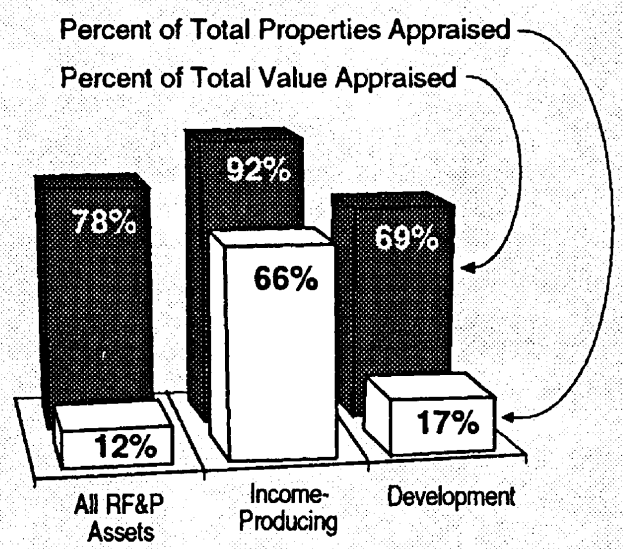
> From May to August [1990] we counseled the VRS on all aspects of its stake in RF&P and on the methods for maximizing the value of that investment. This task . . . required a thorough review of extensive material concerning RF&P's railroad and realty operations, a review of prior unsuccessful negotiations between RF&P and CSX, assistance in negotiating a substantial stock acquisition from Norfolk Southern Corp., advice to VRS concerning its investment banking relationships, and research of tax and corporate issues.
>
> In August and September [of 1990] our firm's representation of VRS changed as the VRS moved to the next stage of its RF&P investment — the negotiation of an agreement in principle with CSX Corp. for the acquisition of its interest in RF&P on terms designed to enhance VRS' overall investment. [This] final stage involves intensive due diligence and the preparation of definitive documentation for such an agreement. At this point, both VRS and CSX have presented a proposal to a Special Committee of the Board of Directors of RF&P. Meanwhile, due diligence — a time consuming review of RF&P's complex rail and realty business — is underway. If the current or revised proposal is accepted, further due diligence will be required, including an intensive review of all RF&P realty and leasehold interests. Of course, VRS will also require counsel to prepare and review legal documents concerning RF&P's repurchase of its shares, the sale of RF&P's railroad assets to CSX, the sale of CSX's interest in RF&P to VRS, and other related transactions. All of these agreements involve complex realty, tax, corporate, and securities law issues.

Real Estate Appraisals. In order to properly execute the valuations of RF&P's real estate assets, PaineWebber hired the real estate brokerage and appraisal firm of Cushman and Wakefield. This company was responsible for conducting appraisals for the purpose of developing a valuation report on RF&P properties. As Figure 8 illustrates, Cushman and Wakefield focused its efforts on RF&P's most valuable assets. Although only seven of RF&P's 58 properties were appraised (12 percent), these seven properties constituted more than 78 percent of RF&P's total portfolio.

Four appraisals were conducted on a subset of RF&P's income-producing properties. The total value of these properties according to the report were $197 million. This constituted 92 percent of the total value of RF&P's income-producing assets.

Figure 8

Scope of Appraisals Conducted by Firm Employed to Value RF&P's Assets



Source: Paine Webber's presentation to the VRS Board of Trustees, August 26, 1991.

A similar approach was used to appraise RF&P's 5,000 acres of raw land holdings. In light of their relatively small values, full appraisals were not performed on the company's more than 2,300 acres of non-principal raw land. Instead, Cushman and Wakefield targeted RF&P's 2,626 acres of principal raw land that had development potential and identified what the appraisers concluded were the key properties in the portfolio. Though these appraisals were conducted for only 17 percent of the principal land holdings, these assets were valued at $174 million. This represented 69 percent of the total value of RF&P's principal land holdings at the time of the acquisition.

In addition to the Cushman and Wakefield appraisal, the Board also had access to two other appraisals that were conducted for RF&P in the two years prior to the acquisition. The JLARC real estate panel examined all three sets of appraisals and concluded that the appraisals did provide a sufficient amount and quality of information to allow the VRS Board to make a reasonable decision on whether to acquire RF&P.

Environmental Assessments. In light of the importance of raw land in RF&P's portfolio, the VRS Board had to give some attention to the potential problem of site contamination. When valuing raw land, real estate appraisers will consider the economic impact of site contamination if they have access to any environmental studies for the relevant parcels.

Additionally, preliminary judgments about the probability of site contamination are often made based on the historical use of the property and through interviews with local officials. Nonetheless, appraisers are not environmental experts. Hence, when there is a legitimate reason to expect that some contamination may exist on certain key properties, appraisers should not be relied upon as the sole source of information on the magnitude of potential hazardous waste problems.

As noted earlier, RF&P's assets include more than 5,000 acres of raw land, all of which could not be evaluated prior to the acquisition. Considering the relatively small value of RF&P's surplus properties and the historical use (e.g. agriculture) of some of its other principal land holdings, only certain key properties were studied.

Specifically, the VRS Board relied on existing environmental studies of some sites and retained a firm which specializes in assessing environmental liabilities to examine any problems at the Potomac Yard site. The company, Environs, performed a site assessment at Potomac Yard at a cost to VRS of approximately $30,000.

As discussed later, this was a preliminary assessment. Before RF&P can develop this site, the Environmental Protection Agency will have to complete its analysis of the property. While the work conducted by Environs is viewed by the Board as providing a reasonable estimate of RF&P's environmental liability, a final determination of these costs have yet to be made.

VRS Board Made a Prudent Decision to Acquire the RF&P Corporation

Completely apart from the question of whether the VRS Board of Trustees hired the appropriate experts to evaluate this acquisition is the issue of whether it was reasonable for the Board to purchase the RF&P. This concern has been raised because the acquisition cost for the RF&P reported on the books of a VRS holding company and the pension fund presently totals $531 million — a price which can not be justified by the apparent net value of RF&P's assets of $385 million.

According to the legal and accounting consultants who examined this issue for JLARC, this conclusion is based on two faulty assumptions — one dealing with the acquisition price and the other dealing with the economic value of the company. When the acquisition cost and asset values are properly stated, it is clear that the Board's decision to acquire the company was prudent.

The Acquisition Cost of the RF&P. In evaluating the economics of VRS' decision to purchase the RF&P Corporation, it is necessary to first examine the cost of the acquisition. As noted in Chapter I, the Commonwealth of Virginia purchased a 20 percent interest in the RF&P Corporation in 1836 at a cost of $275,200. In 1970, by State statute, the General Assembly placed a revised value on these shares and transferred them from the general fund to the VRS as part of its obligation to make retirement contributions for its employees.

However, because it retained the right to recover the stock at the value assigned to it in legislation, it was able in subsequent years to re-acquire these shares and immediately direct VRS to repurchase them at the then market value. To effect this repurchase the VRS paid to the general fund an amount equal to the difference between the value of the stock as reported on VRS books and a statutorily prescribed value.

In 1991, after VRS proposed to acquire all outstanding shares of RF&P, the General Assembly removed the restrictions on the stock in a transaction similar to the previous stock transfers. The value prescribed in statute for this transaction was $48.21 per share. As Exhibit 1 shows, when the aggregate amount of cash transferred in these transactions are added to the amount VRS paid third parties (e.g. CSX, other public shareholders), the VRS Board appeared to pay $547 million to purchase the company.

The Value of RF&P Assets. At the time of the acquisition, RF&P's assets were revalued as required for GAAP accounting. The total value was stated at $653.2 million. This amount was reduced by the amount of deferred taxes, estimated at $214.7 million, as well as other liabilities and accounts payable. The net value of the company was stated at $385 million as a result.

This amount was substantially lower than the apparent purchase price of $547 million. To account for the difference, the Auditor of Public Accounts determined that the market value for the stock was $39 per share and required VRS to take an immediate write down against pension fund assets of $16 million (the difference between the $48.21 charged by the State for its share and the $39 benchmark used by the Auditor). The remaining difference — $151 million — between the fair value of the stock after the write-off ($532 million), and the equity of RF&P as reported on the company's books ($380 million), is being amortized over 20 years by the VRS holding company, SHI, as goodwill.

This results in a reduction of $7.5 million per year against the income of the RF&P which is estimated to be from $8.5 million to $9 million per year. Some may view this write-off as the recognition of a loss, leading them to inaccurately conclude that the Board's decision to purchase the company was unreasonable.

The Economics of VRS' Purchase of the RF&P Revisited. According to the JLARC legal and accounting consultants, the assumptions related to both the purchase price and the value of the company should be revised. First, according to the consultants, including the transfers in the cash purchases of RF&P is not a realistic method for evaluating the acquisition cost. These transactions were non-arms length transfers between related parties — the General Assembly and VRS — and should be disregarded on those grounds. According to Securities Exchange Commission rules, in accounting for the cost of an asset, purchases of property between related parties should be disregarded because there is no independent market evaluation of the transaction. This establishes an acquisition cost for VRS of $379.4 million.

It is more accurate to view the stock transfers as adjustments to the Commonwealth's obligation to contribute to VRS on behalf of its employees. Since the General Assembly essentially withheld funds from the VRS pension fund using RF&P as a benchmark, its future obligations to the fund may in fact be affected by the performance of the stock. While it is unlikely that this investment will produce an immediate realization of value to offset the funds withheld through the stock transfers, the quality of RF&P's assets should prove adequate in the long run to accomplish this objective.

Exhibit 1

Impact of Stock Transfers on RF&P Transaction

	HISTORICAL COST (RF&P BOOKS)	ACTUAL PAYMENTS (VRS BOOKS)
July 1, 1970 Tranfer of RF&P Shares to Commonwealth	—	$8,660,000
Dec. 12, 1986 Stock Transfer	—	$28,190,000
June 19, 1987 Stock Transfer	—	$57,908,400
June 20, 1989 Stock Transfer	—	$3,509,600
June 28, 1991 VRS Payment to Obtain Title to Shares	—	+ $70,916,616
Total Cost of 3,509,600 Shares Prior to Acquisition	$275,200*	$169,185,416
1991 New Purchases 1,317,450 Shares	$45,281,912	$45,281,912
October 9, 1991 Purchase from CSX 1,317,450 Shares	$105,829,485	$105,829,485
Tender Offer by SHI at $39/Share	+ $228,311,187	+ $228,311,187
SUBTOTAL	$379,697,784	$548,608,000
Cash Received by VRS for Fractional Shares	—	+ ($1,108,610)
TOTAL COST	$379,697,784	$547,499,390

*Represents historical cost of RF&P shares purchased by the Commonwealth of Virginia in 1836.

Source: The Virginia Retirement System.

Had the VRS Board refused to acquire RF&P based on the position that the cumulative effect of the stock transfers made the purchase too costly, there may well have been additional losses for the Commonwealth. The most important of these would have been the loss of the possibility to earn from the investment the funds which had already in effect been appropriated from the pension fund to the general fund through the stock transfers.

Second, in terms of RF&P's long-term value, the JLARC consultants point out that the amount of the deferred tax liability is overstated. The consultants report that this is the case because:

> In reality, the deferred taxes will not be paid for several years, if ever, and thus the actual present value of the taxes to be paid in economic terms is far less than the deferred tax liability shown on RF&P's balance sheet. The deferred tax liability should be discounted to its present value to portray accurately the value of the company because . . . a purchaser of the stock views the deferred tax liability as an implicit tax. If, for example, our tax laws required the recognition of all corporate gain at the time a change in ownership occurred, then the deferred taxes as computed for GAAP [Generally Accepted Accounting Principles] purposes (reporting a liability at its face amount as though the assets were sold on that date) would reflect the actual net values. However, where the tax is not due on sale, the fair market value of the stock — what a willing buyer would pay for the future cash flow from the property — reflects the estimated future taxes discounted to the present.

The consultants estimate the discounted present value of the tax liabilities to be $84.4 million, instead of $214 million as carried on RF&P's books. Therefore, the value of the VRS interest in RF&P is $478.6 million. Viewed in this light, the decision by the Board to spend $379 million to acquire $478 million in assets appears reasonable and prudent.

Future Valuation of RF&P's Stock. Still unaddressed is the question of what value should be placed on all of RF&P stock, including the 20 percent that was originally owned by the State. Currently, this is not a pressing issue because the company is no longer publicly traded. However, if the State decided to reduce its risks in the RF&P by issuing stock, the question of value would resurface.

The consultants for this study used the values determined by the RF&P for its assets to establish a measure of the company's present worth. As noted above, with these values it can be shown that VRS paid $378.2 million to unrelated third parties for 74 percent of the company. This price infers a value for 100 percent of the stock of $509 million ($378.21 million/.7424). After deducting the company's present liabilities, most notably the discounted present value of the RF&P's deferred tax liability, the underlying value of RF&P's assets is $478 million. This is approximately $31 million less than the $509 million imputed value of the stock.

When the tax liabilities are considered using conservative assumptions about their discounted present value as discussed above, potential investors with short investment horizons may conclude that VRS paid a premium for the company. Consequently, the value of RF&P stock on the open market will likely be greater for investors whose time horizons for the development of raw land are consistent with VRS. This is because the impact of the RF&P's tax liabilities can be greatly minimized with the appropriate development plan.

Still, before serious consideration is given to reissuing the stock of RF&P, there are a number of important tax planning and development issues which need to be resolved. The next section of this chapter discusses the RF&P's deferred tax liabilities in more detail.

THE IMPACT OF RF&P'S DEFERRED TAX LIABILITIES

Much of the complexity concerning VRS' acquisition of RF&P is related to the company's tax status and the nature of its taxable assets. Although RF&P is owned by a tax exempt public entity, because it is a "C" corporation, the income that it earns or realizes from its assets is subject to both federal and state taxes.

Currently, RF&P has two substantial deferred tax liabilities. One is based on the potential gain associated primarily with the appreciation in its real estate assets. The other potential liability, which RF&P asserts does not exist, is based on a complicated restructuring of the company which occurred in 1988, prior to the VRS acquisition. However, in both cases, these taxes are considered deferred and do not have to be paid unless there is a sale of the assets or a reorganization of certain subsidiaries. Consequently, if VRS were to liquidate RF&P, it would likely be required to pay up to $454 million in federal and State taxes.

It appears that the VRS Board was informed, at the time of the acquisition, of these potential liabilities and the limitations they posed pertaining to the liquidation of RF&P or the sale of its key assets. The professional advice the Board received supported its plan to hold these assets essentially tax-free for long term development purposes. While the VRS Board acted prudently based on this advice, some of the trustees should have pressed their legal counsel for additional, more detailed information.

Although the tax liabilities do not prevent the effective implementation of various long-term development plans for some of the company's raw land, the potential liability related to the corporate restructuring could constrain at least one of the RF&P's preferred tax planning options. Without a favorable tax ruling from the IRS, this liability, if it exists, could make it more difficult for the RF&P to generate tax-free income for VRS from some of its key properties. It does not appear that the VRS Board fully understood this issue at the time of the acquisition.

One of RF&P's Tax Liabilities Is Based Mostly on the Appreciation of Its Assets

Under current federal tax laws, a private corporation must recognize a taxable gain when it sells property. Generally, the corporation's adjusted tax basis is equal to the corporation's cost of the property (its basis), minus any deductions taken with respect to the property. The following example illustrates how the tax is calculated.

> *Corporation A has a parcel of land that was purchased for $1. Ten years later Corporation A sells this asset for $100. The gain on this sale equals $99 ($100-$1). Therefore, assuming a combined federal and state tax rate of 38 percent, the tax faced by Corporation A for this sale would be $37.62 (($100-1) x .38).*

It is important to note that as long as the assets are not sold, the deferred tax is actually implicit. In other words, it does not have to be paid. However, if a company is acquired, General Accepted Accounting Principles (GAAP) dictate the circumstances under which these implicit taxes must be reported on the company's balance sheet even when there has been no sale of the corporation's assets. This is generally done under purchase accounting guidelines.

Specifically, when an investor such as VRS, purchases 100 percent of the stock in a corporation, the transaction is viewed as a purchase of the underlying assets. In such cases, the assets are "written up" to reflect their market value. Therefore, the difference between the original cost of the asset (it basis) and this new fair market value becomes the gain on which the implicit tax is computed and recorded on the corporation's balance sheet. The following illustrates how this tax would be calculated and recognized on a company's balance sheet even though it was not paid.

> *Corporation A owns one asset — a parcel of land for which it paid $1 in 1970. Twenty years later, all of the stock for this corporation is purchased by Corporation B for $100. On the books of Corporation A, the value of its land is restated to $100, reflecting a gain of $99. The implicit tax is recorded as a long-term deferred tax liability of $37.62 ((100-1) x .38).*

Factors Which May Affect a Company's Deferred Tax Liability. There are a number of factors which can increase a company's deferred tax liability by acting to lower the basis (original cost) of the assets. One such factor is the method for depreciating the asset. The most frequently encountered situation in which this type of liability surfaces is when corporations use an accelerated depreciation schedule for tax purposes and a straight-line method for financial reporting.

In such circumstances, a corporation will record on its books the payment of certain taxes which have actually been deferred due to the use of an accelerated depreciation schedule. To reflect the fact that these taxes, though reported on financial statements, have yet to be paid, the company records the specific amount as a deferred tax liability on its balance sheet.

RF&P Deferred Tax Liability Related to Low Basis in Its Assets. Because of the length of time that RF&P has owned some of its most valuable real estate, the difference between the original purchase price of these assets and their fair market value is substantial. Primarily as a result of this appreciation, which includes adjustments that RF&P has historically made to the basis of its assets, the company's deferred tax liability in 1991 was more than $214 million. Approximately 90 percent of this figure can be specifically attributed to asset appreciation.

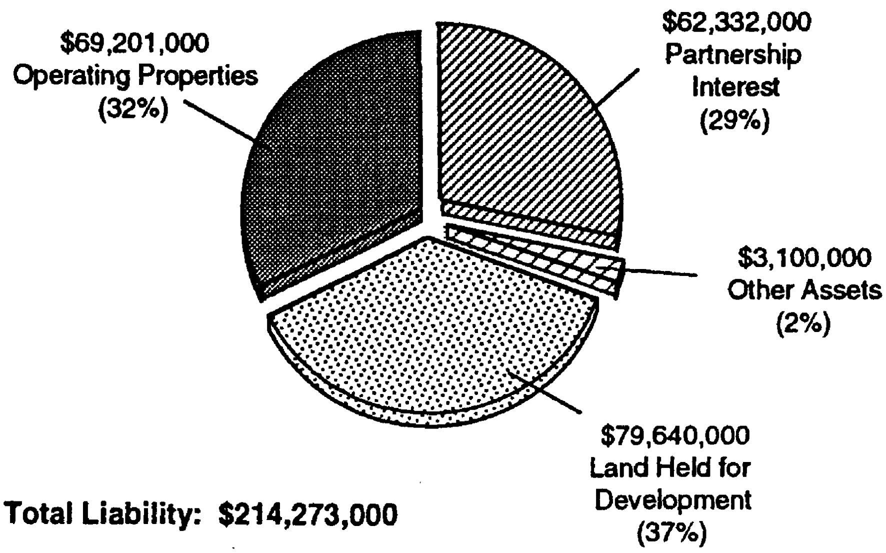
As Figure 9 indicates, 37 percent of this deferred tax can be attributed to land held for development. Another 32 percent is associated with RF&P's operating properties, while 29 percent is based on the company's partnership interests.

The difference between the value of RF&P's assets as reported on the company's balance sheet and the tax basis for the land is considerable for two of its most valuable properties — Crystal City and Potomac Yard. When VRS purchased RF&P in 1991, the value of Crystal City property was recorded at $250 million. Although this property has considerable value, RF&P acquired the land in the 1950s for slightly more than $150,000.

Since that time, RF&P has received significant cash distributions from the partnerships created to develop this land and has deferred any related income tax

Figure 9

RF&P's Long-Term Deferred Tax Liability Due to Low Basis of Land



Source: JLARC graphic based on data from RF&P Corporation, 1991.

payments because of its allocable share of partnership debt. This has created a negative $68 million tax base in this asset (Figure 10). If this asset were sold for its stated market value, the tax on this deferred gain would be approximately $121 million.

A small portion of the deferred tax on these partnerships will become due without a sale. This is true because the deferred taxes will be paid as the partnership assets are depreciated. However, over the next ten years, RF&P's book depreciation for its partnerships will only be slightly different from its tax depreciation.

In terms of magnitude, a similar tax problem exists for the Potomac Yard asset. Purchased in the early 1900s for $152,000, this land's value was restated at $113 million with VRS' acquisition of RF&P in 1991. Assuming a 38 percent statutory tax on this type gain, RF&P would face a liability of $43 million for the sale of Potomac Yard.

Most of RF&P other properties do not have such a low basis because many were more recently acquired, except for those purchased with condemnation proceeds. Under federal law, any property purchased within three years using proceeds from federally condemned real estate assumes the cost basis of the land that was condemned. However, the value of these properties relative to Crystal City and Potomac Yard is minimal.

Figure 10

Calculation of Taxes Payable Upon Sale of RF&P Holdings

Formulas for Calculation:

(Market Value) — (minus) (Land's Basis + Partnership Distributions (may be negative)) = (equals) (Gain)

(Gain) X (times) (Statutory Capital Gains Tax) = (equals) (Tax Liability)

Applied to Crystal City:

($250.3 Million) — (−$68 Million) = ($318.3 Million)

($318.3 Million) X (38%) = ($121 Million)

Applied to Potomac Yard:

($113.2 Million) — ($152 Thousand) = ($113.05 Million)

($113.05 Million) X (38%) = ($43 Million)

Source: JLARC staff analysis of RF&P financial data.

RF&P's Other Deferred Tax Liability Is Due to a Corporate Restructuring

RF&P's second possible liability is considerably more complex. This potential tax liability was derived from a corporate restructuring which was undertaken by the company in 1988. The purpose of this restructuring was to convert the railroad operating company into a holding company structure. Although the records documenting the rationale for this restructuring are somewhat obscure, it appears that the company's board of directors wanted to capitalize on the enhanced value of its railroad assets without being encumbered by the business practices of a unionized railroad.

Figure 11 illustrates how the company was restructured. As indicated, prior to 1988, RF&P Railroad was the parent company to two subsidiary corporations — Richmond Land Company and RF&P Development. The following summarizes the key steps in the reorganization:

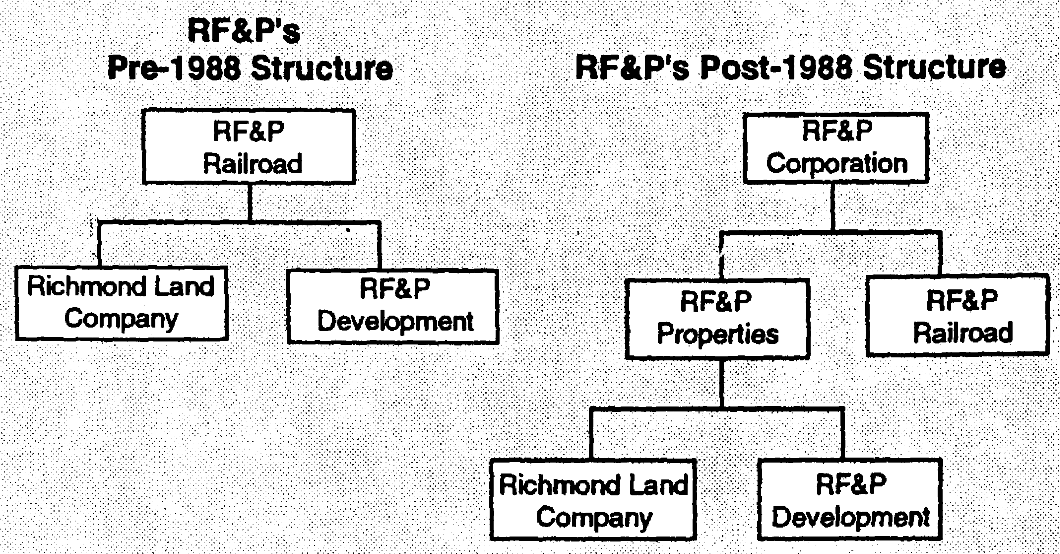
- First, a company called RF&P Properties was formed.
- Second, RF&P Railroad which was the parent company for two subsidiary corporations — Richmond Land and RF&P Development — contributed to RF&P Properties, the stock of these subsidiaries along with all of its real estate assets in exchange for the stock of RF&P Properties.
- Third, a holding company called RF&P Corporation was formed. Then, substantially all of the stock of RF&P Railroad was exchanged for the stock of RF&P Corporation.
- Fourth, all of the stock of RF&P Properties that was held by RF&P Railroad was distributed to RF&P Corporation.

In this complex reorganization, the tax basis of the real estate assets which were transferred to RF&P Properties was lower than the fair market value of RF&P Properties stock which had been transferred to RF&P Railroad. This could have created an unrecognized gain which the legal and accounting consultants for this study estimate at approximately $630 million. Because this potential gain is derived from one of the transactions in the restructuring, it could be considered a structural tax liability.

Magnitude of Tax Liability. When the reorganization was conducted, RF&P management requested a ruling from the IRS on whether the gain created by the restructuring was taxable. The IRS ruled that to the extent the restructuring is treated as a gain, it would be taxable. Based on the current tax rate of 38 percent, if it is a gain and this liability were triggered, it would cost RF&P about $240 million ($631 million x .38).

Some events that would trigger this tax include the sale of certain assets outside of the consolidated group of subsidiaries that were created in the reorganization. Also, if RF&P Railroad (the company which distributed the assets), or RF&P Corporation (the company which owns the relevant assets) leaves the consolidated group, the tax would be triggered.

Figure 11



Source: RF&P Corporation.

Tax Ruling Could Eliminate Potential Liability. It is possible that RF&P could receive a ruling that supports the company's position on this issue — that the reorganization did not create a taxable gain when the reorganization was conducted in 1988. To qualify for this ruling, RF&P will have to show that both RF&P Railroad and RF&P Properties were engaged in a five-year trade and had a business purpose which supported the distribution of RF&P Properties stock. Because the previous ruling did not address this issue, RF&P has to proceed as if the reorganization created a taxable deferred gain.

Board's Knowledge of Tax Liability. The size and potential impact of RF&P's deferred tax liabilities raise important questions about the consideration the VRS Board gave to this issue prior to purchasing the company. Of particular interest is whether the VRS Board was both aware of these liabilities and factored them into the decisionmaking process.

Based on interviews with VRS Board members and a review of some of the documents for the transaction, it appears that the Board was informed of the tax liabilities and the problems that they posed if key assets were sold or if the company were liquidated. As the following comments illustrate, Board members viewed the acquisition of RF&P as a long term investment and they had no plans to sell the assets or liquidate the company.

> [The plan of the Board was to] convert this asset into cash over time. We thought the best way to do this would be to run RF&P as an investment company with the outside expertise to develop the prop-

erty. The Board never for one minute considered selling off RF&P's major properties.

* * *

I knew the deal had to be structured in such a way so that a stock gain and the associated tax liability would not be triggered. I also knew that we could not sell or dispose of the property due to tax issues. The Board never purchased the RF&P with the intent to sell it. Development was the only plan for this asset. The Board saw the RF&P as a long term development. The acquisition was not made with leveraged money so there was no pressure to put a building up tomorrow.

* * *

The question of tax liability was probed most heavily by [another board member.] We were aware that certain liabilities would be triggered if certain assets were sold. However, we knew that we wanted to hold onto the assets and develop them, so the tax liability was not an immediate concern.

* * *

The only objective the Board had in purchasing RF&P was long term development. The Crystal City development project [a partnership with a developer using ground leases] was seen as the model. We knew that some of the surplus land would be sold off but the key to this deal was the development of Potomac Yard. This is why we were not concerned about the tax liability question.

While JLARC's interviews of VRS Board members and the professional advisors to the Board do indicate that the trustees were aware of the tax liabilities, this is an extremely complicated issue and members should have pressed their advisors for greater details. The Board was accurately informed that RF&P's raw land could be developed without triggering the tax liabilities. However, if the goal were to develop these properties in a manner that would generate tax-free income to the pension fund, some members of the Board should have been better informed about the difficulty of achieving that goal.

For example, one of the best available options for creating tax-free income for VRS is through the formation of a real estate investment trust (REIT). A REIT is a form of a corporation that combines capital from a pool of investors which can then be used to finance real estate. In effect, REITs provide individual and tax exempt investors with the opportunity to acquire an interest in commercial real estate projects. Most importantly, any income received from the REIT is substantially enhanced because it is not taxed at the federal level.

Because of the non-taxable nature of REITs, RF&P management is considering proposing the use of this vehicle as a means of producing tax-free income for VRS. In order to convert the corporation into a REIT, the company must sell shares of its stock which would require a change to the corporate structure of the company.

However, because of the reorganization which was implemented in 1988, such a restructuring would trigger the structural tax liability discussed earlier. To avoid this potential problem, RF&P needs a favorable ruling from the IRS eliminating its structural deferred tax liability. Without this ruling, RF&P will have to pursue other less certain options such as complex partnerships to achieve the same goal. This issue was not fully understood by some members of the VRS Board at the time of the acquisition.

The Liquidation of the RF&P Corporation Would Be Imprudent

Since VRS acquired RF&P in October of 1991, some have questioned whether the pension fund should have majority interest in a real estate company with such a large quantity of undeveloped land. Part of this concern is based on legitimate policy questions pertaining to the ability of VRS to manage the relationship between a public entity and a private corporation. More specifically, there is some doubt about whether the demands of public accountability can be effectively addressed within the operational framework which has been established for the investment.

Another concern is whether it is indeed too risky for VRS to own 100 percent of a real estate corporation whose mission over the next 20 years will be to convert a large tract of land in Northern Virginia into a commercial and residential development project. In light of the disputes over the procurement of contractors, questions about development rights, and unresolved environmental concerns which are inevitable for this type investment, some have concluded that VRS should liquidate RF&P.

Members of the VRS Board acknowledge there is risk associated with the attempt to successfully manage the development of Potomac Yard. However, they contend that the value of RF&P's assets and the potential income that could be generated from this investment offset these risks in the long term. This, it is suggested argues against a liquidation of the company or a sale of RF&P's key assets in Northern Virginia.

Based on the tax findings presented in this report, it would be imprudent for VRS to liquidate its interest in the RF&P. If such a liquidation did occur, deferred tax liabilities which can be minimized over time through careful planning will be triggered. Specifically, in light of the company's current deferred liabilities and assuming VRS received a fair market value for RF&P's assets in an orderly liquidation, it would be required to pay more than $440 million in federal taxes.

Rather than liquidate the company, the consultants retained by JLARC for this study conclude that it would be more beneficial to pursue business strategies which minimize RF&P's tax liabilities and offer the benefit of an enhanced income stream from the company's key assets. According to the real estate consultants, the rationale for this approach is as follows:

> In view of the severe losses that will likely face VRS should it try to quickly sell the RF&P land portfolio, it seems advisable to utilize an orderly combination of acquisition of improved cash-generating properties, develop the best land parcels, and either hold the other parcels until the market is more favorable or sell at reasonable prices as buyers can be obtained.

The legal and accounting consultants offered a similar conclusion:

> We conclude that realization of an appropriate return for these valuable properties will require time and careful planning, but that this course of action, given the possibilities of minimizing the RF&P's tax liabilities through the use of appropriate vehicles will be far superior to prompt liquidation of RF&P and distribution of its real estate assets to SHI or VRS. Liquidation will result in an immediate recognition of all of the company's internal tax liabilities, incurring a tax liability which is 70-80% of the value of the company's assets.

These views are consistent with RF&P' plans for the management of its assets. To understand how the company plans to accomplish this, and whether its proposed strategy is feasible, it is first important to understand the nature of the investment.

The last section in this chapter examines the investment value of RF&P. It includes a discussion of the short and long-term benefits of the investment and an assessment of some of the potential risks associated with the development of RF&P's raw land, in particular, Potomac Yard.

THE INVESTMENT VALUE OF THE RF&P CORPORATION

Judgments about the value or quality of RF&P as an investment for the State's pension system must consider the diversity of the RF&P's assets and the Board's purpose in acquiring the company. Although RF&P's assets include valuable, income-producing commercial real estate, the company also owns a substantial amount of undeveloped land. Presently, the most valuable parcels of land produce no capital return, an insignificant amount of real estate income, and are unlikely to experience appreciation in the near future. Consequently, as a short term investment RF&P is unsatisfactory.

However, members of the VRS Board point out that the investment in the RF&P was made for the long term. It was explicitly considered as a mechanism for diversifying the pension fund as a hedge against inflation and as a means to create an interest for the pension fund in the substantial investment potential of Potomac Yard.

Viewed in this light, a different picture of this investment emerges. RF&P's key income-yielding properties are extremely valuable, appear to be capably managed, and produce a steady income stream. More importantly, these properties, as well as RF&P's

most valuable raw land holdings, are strategically located in perhaps the best market for commercial real estate in the State.

Due to the value of these properties, the potential for developing a substantial and steady income stream for the pension fund is strong. Also, it is likely that these properties will experience a considerable amount of capital appreciation in the future. Based on this, the real estate panel for this study concluded that the RF&P is a reasonable long-term investment for the pension fund:

> RF&P is judged to be an unsatisfactory short-term investment for VRS inasmuch as it produces insufficient rental income, essentially no capital return, no capital appreciation, and no income tax advantage. Yet in the long run, the RF&P investment can be both prudent and sound, especially due to the potential for capital appreciation of its strategically located key properties and diversification of the VRS investment portfolio.

Still, if the long-term potential of this investment is to be realized, RF&P staff will have to successfully manage the risks associated with this project. This includes the need to negotiate favorable land use terms for its raw land at Potomac Yard, work out satisfactory agreements with the National Park Service and local officials on infrastructure issues, and keep development costs at a reasonable level.

RF&P Is Not an Adequate Short-Term Investment Due to Its Raw Land

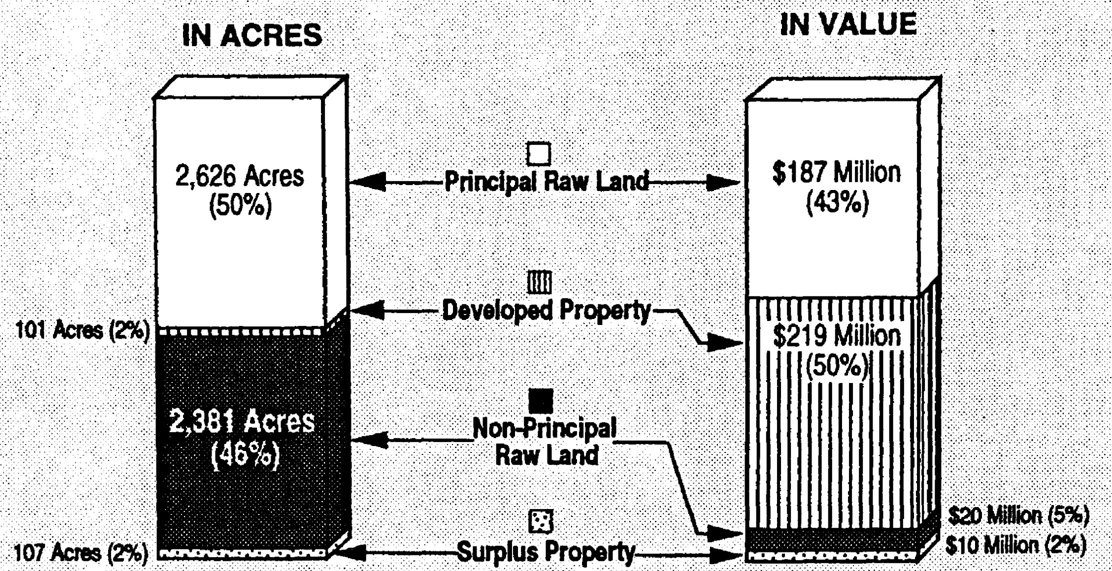
Real estate investments can offer a number of advantages for a pension fund. One of the main benefits of this type of investment is that it provides attractive portfolio diversification opportunities. Studies have shown that real estate is the only asset category that is generally inversely related to bonds and is unrelated to stock returns in the short run. This gives it the attractive quality of being a hedge against inflationary spikes in the economy. However, when a real estate portfolio includes a substantial amount of undeveloped land, some of its benefits as a vehicle for diversification can be temporarily lost.

Impact of RF&P's Undeveloped Land. Based only on its real estate assets, data collected from the RF&P indicate that virtually all (98 percent) of its 5,216 acres of land is undeveloped (Figure 12). Approximately one half of the acreage is considered by RF&P management to be principal land holdings. Another 48 percent of the company's acreage is considered non-principal raw land.

However, it is important to note that on the basis of value, RF&P's developed land represents a disproportionate share of the company's asset values. Specifically, though the developed properties represent just two percent of the company's total land holdings by acreage, they account for one-half of the real estate value. RF&P's principal raw land, which consists mostly of Potomac Yard, represents 43 percent of value. Relative to these assets, the company's non-principal and surplus land holdings are worth considerably less (seven percent).

Figure 12

Type and Value of
RF&P's Real Estate Assets



Source: JLARC's Real Estate Panel.

Still, with Potomac Yard, the impact of this undeveloped land on the company's short term investment performance should not be understated. One of the most important measures of performance for real estate assets is the overall rate of return. As Figure 13 shows, in 1992 the overall rate of return for RF&P's real estate assets was only 3.29 percent. This is 23 percent less than the returns produced by VRS' other real estate assets for the same time period.

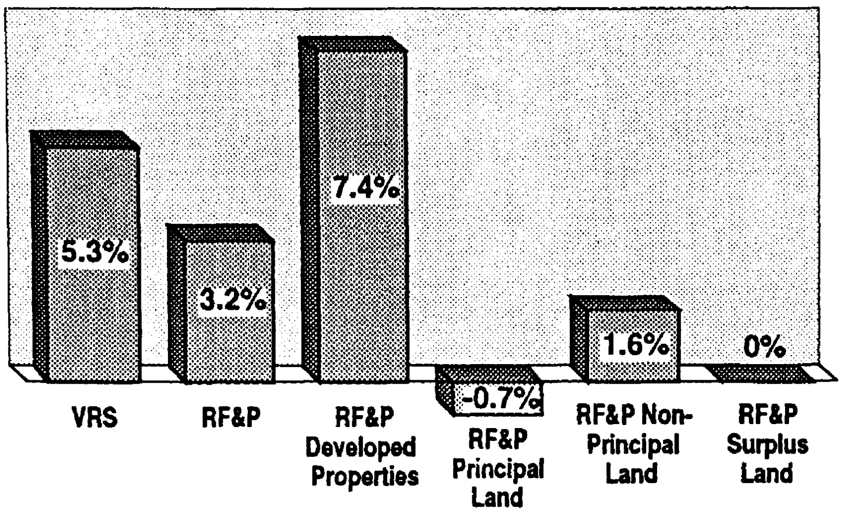
Clearly the reason for this comparatively small return is the company's undeveloped land. Specifically, RF&P's principal land holdings, which include Potomac Yard, had a negative cash flow in 1992. In other words, the expenses for maintaining these properties (e.g. real estate taxes) were greater than the actual income produced by the assets.

In some circumstances, the opportunity cost associated with investing in raw land can be offset by appreciation in the value of the property. Since appreciation would be included in the value of the asset for actuarial purposes, this would mitigate some of the financial impact to the pension fund of having an asset which produced no income in the short term.

However, the VRS Board purchased RF&P at a time when the commercial real estate market, both locally and nationally, had begun to falter. Vacancies rates were up and property values, especially for large tracts of land like Potomac Yard had begun to

Figure 13

Comparison of the Performance of the VRS' Real Estate Portfolios to the RF&P Corporation, 1992



Source: JLARC's Real Estate Panel.

decline substantially. While these factors may have allowed VRS to negotiate a very satisfactory purchase price for RF&P, they decreased the probability that the properties will generate substantial appreciation in the short term.

RF&P Is a Reasonable Long-Term Investment for the State's Pension Fund

While VRS' investment in RF&P has some limitations in the short term, Board members indicate that this investment was not meant to become an immediate cash yielding vehicle for the pension fund. The goal in purchasing RF&P was to acquire an interest in the potential real estate development in Potomac Yard. In addition, Crystal City was viewed as a stable commercial and residential development that could provide the pension system with a steady stream of income while Potomac Yard was being developed.

The real estate consultants who evaluated the RF&P investment for JLARC conclude that the Board's assessment of the long-term benefits has some merit. Both the quality of RF&P's cash yielding assets and the strategically located parcel of land at Potomac Yard offers a range of investment possibilities.

RF&P's Income-Producing Properties. Although RF&P's overall returns do not compare favorably to other VRS properties, if the income from its developed properties is considered separately, a somewhat different picture of performance emerges.

In 1992, RF&P's income-producing properties produced an overall rate of return of 7 percent (Figure 14). This is 24 percent higher than the performance of VRS' real estate portfolio for the same year.

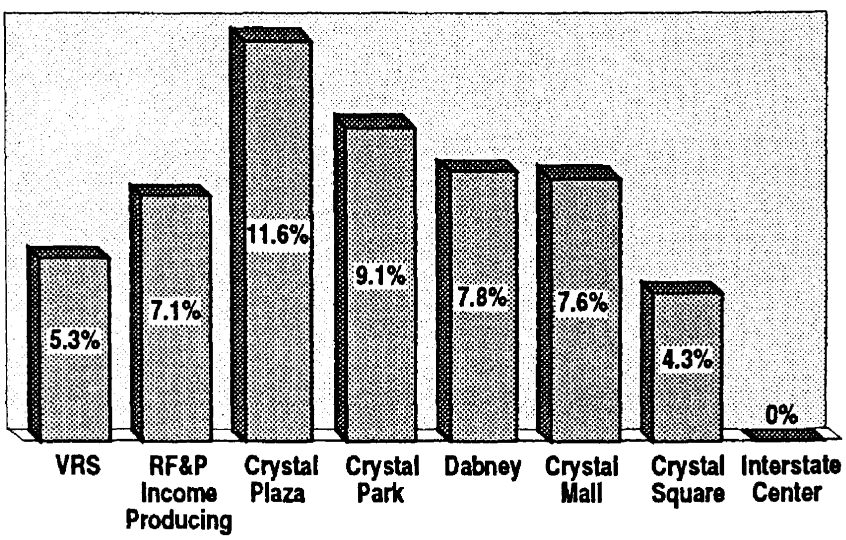
The strength of RF&P's income-producing properties is the partnership it has in the Crystal City development. With one exception, all of the Crystal City properties produced a return that was higher than 7.5 percent. Before RF&P staff acquired two other developed properties in 1993, the 73 acre site at Crystal City (two percent of RF&P's land) accounted for 94 percent of its net operating income.

The company's interest in these properties generally allow RF&P to receive 50 percent of the net cash flow from each building for which RF&P has granted its partner a ground lease. Once these ground leases expire, all of the buildings will revert to RF&P. The earliest reversion date is in the year 2023.

According to JLARC's real estate consultants, RF&P's business partner in Crystal City is one of the strongest real estate companies in the area. The company builds high quality commercial real estate and employs more than 2,500 employees who are very familiar with the Washington real estate market. As a result, the occupancy rates for its buildings are consistently higher than the competition. RF&P staff expect this project to provide a consistent source of income over the long term.

Figure 14

Comparison of the Investment Performance of RF&P's Real Developed Properties to VRS' Real Estate, 1992



Source: JLARC's Real Estate Panel.

Potomac Yard Has Both Significant Development Potential and Risks

The most challenging aspect of the investment in the RF&P is the company's 310-acre site at Potomac Yard. Supporters of the Board's decision to acquire RF&P point to this tract of land as the most valuable parcel of undeveloped real estate in the State. With the proper mix of commercial and residential development, some think that Potomac Yard can become one of the most valuable assets in VRS' entire portfolio.

Those who are skeptical about this investment have raised questions about potential environmental problems, zoning disputes, and the sheer magnitude of the work associated with trying to develop this property. These risk factors it has been suggested call this investment into question.

The consultants for this study assessed both the risks and potential cost which will accompany attempts to develop this site. Even considering these factors, they concluded that Potomac Yard has the potential to contribute a sizable cash flow to VRS after it is fully developed in approximately 20 years.

In the interim, the site has the potential to be used for a number of small scale projects which can generate a steady income stream and a substantial capital return. Nonetheless, over the long-term, RF&P staff will have to carefully and successfully manage the myriad of zoning and environmental issues which could potentially threaten successful development of the site.

The Role of Interim Use Projects. As was described earlier, one of the disadvantages to owning raw land is that the cash on cash return is minimal. In the case of Potomac Yard, there is actually a negative cash flow because of the real estate taxes that must be paid. This problem takes on special meaning for Potomac Yard because of the time that it will take to fully develop the entire site. Specifically, the JLARC real estate consultants estimate that development on this site will not reach its highest and best use for 20 to 25 years.

On the other hand, one advantage of Potomac Yard is that it is strategically located in Northern Virginia and can be marketed by RF&P to businesses for interim uses such as parking, warehouse distribution, etc. Typically, interim use plans are smaller scale projects which are used to provide a cash flow to support later more extensive development. Moreover, a portion of the cash flow from interim use projects reduce the opportunity costs of holding raw land.

In addition to the small scale projects, RF&P has targeted a portion of the yard for immediate residential development. A successful development of townhouses and condominiums on a certain segment of Potomac Yard creates the possibility for a substantial return on capital for RF&P. As with the revenue from the interim use projects, these funds can be used to foster more extensive development and defray land maintenance and environmental costs.

Environmental Clean-up Costs. Perhaps the most significant risk created by the investment in the RF&P is environmental clean-up. Based on preliminary site assessment reports and information provided in some of the appraisals, RF&P's total estimated environmental liability is $49 million (Table 4).

Table 4

Environmental Liabilities for the RF&P Corporation

Site	Number of Acres	Contamination	Estimated Cost	RF&P's Liability
L.A. Clarke (Spotsylvania)	26	Creosote	$18 million	$18 million
Davis Industries (Arlington)	1.7	PCB Lead Oil Products	$4 million	$1.17 million
Potomac Yard/ Potomac Greens	342	Petroleum Metals	$16 million	$9 million
Parham Forest (Henrico)	64	Creosote	$11 million	*0
Total	434	N/A	$49 million	$28 million

Notes: *RF&P Railroad and Richmond Land Corporation were named as PRPs by the USEPA for the Rentokil Superfund site in Henrico County adjacent to the 64 acre Parham Forest tract. RF&P's liability results from its ownership of the site, which was leased to Rentokil's predecessor for the operation of a wood treatment facility. Rentokil is negotiating a Consent Decree with the EPA wherein Rentokil will accept responsibility for the cleanup costs. Rentokil and RF&P are in negotiation for the sale of RF&P's contaminated land to Rentokil and the two parties will sign mutual releases.

Source: JLARC's real estate consultants and RF&P staff.

According to RF&P staff, only a portion of these costs must be borne by RF&P. Indeed, only $28 million of the estimated clean-up costs — 57 percent — may have to be paid by RF&P. For Potomac Yard, the liability is $16 million, of which RF&P is responsible for $9 million.

Considering that RF&P has a $100 million cash reserve and a pre-tax annual income of almost $20 million per year, these costs are well within RF&P's financial capacity for managing the site clean-up. However, as noted earlier, these are *estimated* clean-up costs which could change before actual construction on some of the relevant sites begins. The environmental assessments performed by Environs on Potomac Yard were preliminary and designed to meet the due diligence requirements faced by the VRS Board members. Since that time, RF&P has contracted with Environmental Technology Incorporated to complete a more detailed assessment for the Environmental Protection Agency (EPA).

This report is scheduled to be presented to the EPA in 1994. Based on this report, EPA will establish clean-up standards which will indicate the nature and costs of the clean-up. This is one element of risk associated with this investment over which VRS and the RF&P have little control.

Zoning Issues Impacting Development. The zoning issues for Potomac Yard are very complex and if not properly managed, have the potential to undermine the long-term development of that site. Since 1988, officials from RF&P have been working with officials in Alexandria and Arlington on a plan to develop Potomac Yard within the parameters of a plan by the localities to restrict high density development.

After several years of negotiations often characterized by strident disagreement, RF&P and Alexandria agreed to a "Small Area Plan" to develop a portion of Potomac Yard. This agreement provided mutually acceptable compromises between the City and RF&P on allowable amounts of office and retail space, as well as on the number and type of residential units.

Perhaps most important, RF&P agreed to finance the cost of a new Metrorail station. According to company officials, this was a strategic decision designed to spur additional demand for housing and commercial office space.

Despite this agreement, implementation of the plan has been slowed by the National Park Service (NPS). Based on a previous agreement with NPS, RF&P has the right to build an above-grade interchange on the George Washington Memorial Parkway. However, officials in Alexandria have requested that access to the Parkway from the proposed development site be limited to an at-grade, or ground level interchange.

RF&P can proceed and build the above-grade interchange that NPS wants. However, such a move would threaten the development agreements with the local officials in Northern Virginia which the company has worked hard to develop. Moreover, it may require RF&P to use the development rights it has for a portion of Potomac Yard to build more high density commercial office space to offset the higher construction costs associated with building the above-grade interchange.

Management at RF&P has also been working with officials in Arlington on issues related to the Arlington Industrial Area (AIA). In August of 1993, the County Board of Supervisors approved a plan to resolve a suit filed by RF&P concerning contamination of a two acre site within AIA. The following outlines some of the key provisions of the agreement:

- Arlington's responsibility for cleaning up contaminates on the site is reduced to a nominal amount.

- Arlington will receive 21 acres of land on AIA for future public use until the year 2002.

- RF&P will receive credit for one million square feet to be used for building density on Port Potomac.

The problem with this agreement is that RF&P must get a satisfactory monetary settlement for the balance of the AIA site which RF&P alledges has been taken by the Airports Authority. The Airports Authority has made an offer to RF&P for this land which the company judged to be insufficient. This matter will likely be settled in court.

In addition, the NPS has asserted that it can prevent RF&P's development plans for the Port Potomac project that were made possible by an agreement with Arlington. The JLARC real estate consultants indicate that NPS' refusal to do so is linked to RF&P's preference not to build the above grade interchange for the George Washington Memorial Parkway.

By slowing development on Potomac Yard, these disputes increase the opportunity cost of this investment. More importantly, they may be a harbinger of the type of roadblocks RF&P will face as they proceed with more ambitious development plans for the balance of Potomac Yard.

Total Land Development Costs. The specter of potentially large development costs is a major risk that this investment faces. RF&P has not estimated the total development costs for all of its principal land holdings but have given some attention to the development costs of Potomac Yard. These costs have been estimated at $186.5 million.

The JLARC consultants point out that these development costs do not appear unreasonable given the size of Potomac Yard and the income-producing potential of this site. Moreover, to meet these costs, the consultants point out that RF&P has a number of alternative sources of funding so as to preclude the need for support from the pension fund.

However, the real estate panel did find a substantial difference in the development costs for Potomac Yard estimated by RF&P and those cited in one of the appraisals. Specifically, one appraisal projected development costs for this 310 acre site at $283 million. This is 42 percent higher than those now estimated by RF&P. The current costs are lower because the project has been downsized.

If the infrastructure costs for Potomac Yard do begin to exceed the estimates made by RF&P, this will undoubtedly strain the ability of the company to absorb these costs. At the same time, it may increase the temptation for future VRS Boards to provide financing to assist RF&P with development on this project. This according to the consultants would be an imprudent course of action for VRS. As various aspects of the development of Potomac Yard are moved closer to implementation, the management of land development costs at RF&P will have to be closely monitored.

CONCLUSION

VRS purchased the RF&P Corporation as a long-term investment designed to further diversify the VRS portfolio and to provide for significant yields from the future development of Potomac Yard. In making its decision to acquire the company, the VRS Board appears to have had available to it adequate professional advice in all relevant areas.

Based purely on the economic merits of the investment, the decision appears to have been sound. Clearly, the value of the company in terms of its current real estate and other assets and its future earning potential exceeds the acquisition cost to VRS. Finally, given the nature of the company's tax liabilities, liquidation of the company or its properties would not be prudent. Therefore, based on the conclusions of the consultants for this study, it appears that VRS can best maximize its investment return from the company through a combination of long-term development of the principal land holdings and carefully managed disposal of surplus properties.

However, because of the nature of the assets — undeveloped raw land — VRS and RF&P face significant oversight, management, and development obstacles in achieving the Board's intent for the investment. The single most critical question now facing VRS is how it will provide adequate oversight of RF&P to ensure that the company is accountable for its actions. The question facing the RF&P Corporation is how it will manage development of the assets to maximize the VRS interest in the company. These issues are discussed in the next chapter.

III. Oversight and Management of VRS' Investment In RF&P

The acquisition of the RF&P Corporation by the Virginia Retirement System represents the merging of two distinctly different organizational cultures. The first is the culture of State government, a large, highly structured, bureaucratic organization with explicit laws, policies, and operational procedures to govern the decisionmaking process and ensure accountability in the expenditure of State resources.

The other is the culture of a private corporation, the RF&P, which is a 156 year old company, presently experiencing internal shifts in its mission and basic responsibilities. While the RF&P was once a highly structured railroad which owned quality real estate, it is now a real estate company with the sole mission of generating competitive yields for its only shareholder, the State of Virginia. In light of this, important legal, organizational, and corporate governance issues are raised for both VRS and the RF&P.

If RF&P is to be a successful investment, the Commonwealth of Virginia will need to adjust to some aspects of the company's culture of independent thinking and decisionmaking. RF&P, on the other hand, will need to recognize and adjust to some of the accountability requirements of the Commonwealth which at times will clash with norms in the private sector.

Early indications are that both VRS and RF&P have taken a number of positive steps in the management of this relationship but considerable work remains. For VRS, the establishment of a subsidiary corporation — System Holdings Incorporated (SHI) — to hold the stock of RF&P is a legally sound strategy which can serve important governance and oversight functions for VRS. However, in discharging its oversight responsibilities for this investment, the boards of directors for both VRS and SHI must refrain from dictating specific investment plans or proposals to RF&P. The company's investment performance will depend, in large part, on its ability to be managed in a businesslike manner and to remain apolitical.

The issues RF&P faces are decidedly more complex. Due in part to RF&P's deferred tax liabilities and its large amount of undeveloped land, considerable attention has to be given to possible strategies to convert these assets into cash yielding vehicles for the pension fund. The results of this review indicate that RF&P management has developed a solid business strategy and has already initiated steps to plan for the future development of its most valuable parcels of land. The real estate consultants believe that the plan is reasonable but the development timeframe, especially for Potomac Yard, may be overly optimistic.

Still, there are some internal problems at RF&P. Although two years have passed since VRS acquired this company, RF&P has not fully made the transition from a railroad company to a real estate organization. Secured by expensive employment contracts, some of the tradition bound employees of the old railroad company have resisted change and the more aggressive, entrepreneurial style of the new management. In some cases, their skills may not have been sufficient to prepare them for the requirements of the new culture in the company.

So as not to be inhibited by this problem, the company's acting chief executive officer and president has disregarded the company's organizational structure and chain of command to facilitate the development and initial implementation of the business plan. Although this process did enable the company to experience some success in the development of the business plan, it has been executed in a manner that has created some divisiveness among staff.

Moreover, the numerous changes which have been made to the company's board of directors over the last two years and the fact that the chief executive officer is still serving in an interim, part-time capacity, has fostered an atmosphere of instability and uncertainty in the corporation. Until all of these issues are addressed, the company's progress towards the implementation of the business plan and the attainment of investment performance goals will be impaired.

USING A SINGLE PURPOSE CORPORATION TO PROVIDE OVERSIGHT AND ACCOUNTABILITY

In 1991, the independent legal counsel for the retirement system recommended that the VRS Board begin using single-purpose corporations to reduce its liability risks associated with its ownership of real estate. These corporations would have the sole purpose of acquiring and holding properties for the benefit of VRS. Although this recommendation appears unrelated to VRS' subsequent purchase of the RF&P, the Board used changes in the *Code of Virginia* authorizing the use of the corporations to form SHI and granted it the authority to purchase the stock of RF&P.

The mere existence of this holding corporation adds little to the protection from liability that already exists between VRS and RF&P. Moreover, these protections could likely be sustained without SHI as long as the VRS Board maintained a separate identity from RF&P.

However, with the current structure of RF&P, SHI should be retained because it serves important governance functions for the VRS. Given the other demands on the Board's time and attention, it is prudent to delegate the initial oversight responsibility to an independent board of directors. Therefore, as long as VRS continues to own the entire equity interest in RF&P as it is now constituted, it should do so indirectly through SHI.

In carrying out its oversight function, VRS should refrain from micro-managing either SHI or RF&P. To do so would weaken the corporate veil that has been created by this arrangement and expose VRS to the contingent liabilities of RF&P. To the extent that VRS needs to have its real estate investment views considered at the operational level within RF&P, it should use one of its two seats on the RF&P Board to install one real estate professional from the Real Estate Advisory Committee (REAC).

Both RF&P and the Commonwealth of Virginia will need to make adjustments to the new roles which this investment creates for them. RF&P may need to modify some of its policies in recognition of the State's higher standards of accountability. Likewise, the Commonwealth may need to adjust to some of the business practices of RF&P.

Liability Concerns Prompt VRS to Use Holding Companies for Its Real Estate

Preservation of trusts funds is the core fiduciary duty of each trustee. The VRS Board is obligated to be particularly concerned with the exposure of pension fund assets to third-party liability claims arising out of its investments. Such concerns become a major consideration for those investments in which VRS has a controlling interest.

Under these circumstances, there are two types of investments which create present, third-party liability risks for VRS. The first consists of real properties formerly held directly by VRS, but now held in wholly owned single-purpose corporations. The second is the indirect interest VRS has in the RF&P through its ownership of all outstanding shares of SHI. In turn, SHI, owns all of the outstanding shares of RF&P. In assessing these risks, it is important to distinguish between ordinary claims and those claims based on the recent passage of the Comprehensive Environment Response Compensation and Liability Act (CERCLA).

Ordinary Claims and Sovereign Immunity. According to the corporate legal consultant hired by JLARC, both VRS and its employees are probably immune from tort liability claims to the same extent as the Commonwealth for activities conducted within the State of Virginia. However, because this particular issue has never been formally addressed by the courts and is restricted to activities conducted in Virginia, it is not prudent to rely solely on the availability of sovereign immunity as a defense.

Because of this, the legal consultants for this study have concluded that the Board made a responsible decision to organize the real estate assets it held in single-purpose corporations and to use these corporations when it acquires additional properties. Given that the law recognizes the corporation as a separate "person," it is the corporation, and not the shareholders, which is liable for claims or contractual obligations arising out of its operations. This strategy is viewed as providing a "veil" or shield between the corporation and the shareholder.

Piercing the Corporate Veil. Under some circumstances, courts may choose to "pierce the corporate veil" and hold one or more of the shareholders liable for claims against the corporation. While the applicable grounds for veil-piercing are vague, generally proof that the shareholder dominated or controlled the operations of the corporation is a minimum condition. In such circumstances, the risk is obviously greater when there is a sole shareholder as is the case with the State's investment in the RF&P.

Factors relevant to this point include situations in which normal corporate formalities are violated. This may involve cases in which: separate financial records are not kept, corporate funds are commingled with the individual funds of the shareholder, the corporation has no functioning officers, and the shareholder treats the corporation as a mere extension of itself.

Nonetheless, even if these factors are proven, the courts may still refrain from piercing the corporate veil unless it is necessary to avoid "injustice or inequality." Virginia law is quite demanding in this respect and requires evidence that the corporation was used to "disguise wrongs, obscure fraud, or conceal crime."

CERCLA Claims. Under CERCLA, the owner or operator of a facility may be held liable for the costs of cleaning up hazardous waste found at the facility. Sovereign immunity is not a defense and state governments are subject to this law. In as much as RF&P has already acknowledged some contingent liability for environmental clean-up costs and is the owner of large tracts of land, consideration of potential liability for VRS under CERCLA is relevant.

Unfortunately, federal case law interpreting CERCLA is still evolving. The most relevant precedents are those dealing with attempts to impose liability on a parent corporation for the costs of cleaning up the hazardous sites owned or operated by a subsidiary.

Separate cases have resulted in two apparently conflicting lines of authority. As a result, the corporate law consultant for this study concludes that the most effective strategy for shielding pension assets from both ordinary claims and CERCLA liability claims brought against RF&P is to scrupulously maintain both the appearance and the reality of separate corporate identities for VRS, SHI, and the RF&P.

VRS Oversight of RF&P Should Be Diligent but Must Be Conducted with Caution

Initially, requirements to maintain the corporate veil seem to conflict with VRS' equally compelling fiduciary duty to oversee its investment in RF&P and ensure the receipt of an appropriate rate of return. While this conflict is real, it is not irreconcilable.

In the first place, it must be recognized that VRS has neither the obligation nor the legal right to "manage" SHI or RF&P. This authority, under the *Code of Virginia* is vested in the respective corporations' boards of directors. Thus any attempt by VRS to exercise discretionary management authority with respect to the affairs of SHI or RF&P would be without legal effect.

This problem could not be alleviated by dissolving SHI. If VRS owned the stock of RF&P directly (instead of indirectly through SHI) these same restrictions would still apply. Therefore, any circumstance in which VRS was perceived as micro-managing the operations at RF&P could potentially be viewed as a disregard of prescribed corporate governance norms. This would open VRS to charges of "undue" domination and control, with the possible liability consequences previously discussed.

Use of SHI to Provide Oversight. The current SHI Board was appointed in June of 1993. This Board replaced the previous group of directors who were members of the VRS Board or the REAC. Given that VRS can obtain the benefits of the "corporate veil" by holding the RF&P shares directly, the obvious question is whether using SHI as an intermediate holding device serves any useful purpose or simply imposes another bureaucratic layer between VRS and RF&P.

In as much as the sole ownership of an operating corporation is a highly unusual investment for any pension fund requiring a great deal of oversight, it seems prudent to delegate the initial oversight responsibility to an independent body, like SHI, with its own directors. In this role, SHI can be held to perform the critically important role of screening information from RF&P to ensure that VRS is kept apprised of the details of company operations but not so overwhelmed that it is distracted from its other duties associated with overseeing a $15 billion pension fund.

Since June of 1993, RF&P's president has been meeting with the recently-appointed SHI directors on a monthly basis to discuss various issues concerning RF&P. The initial emphasis of these meetings has been on familiarizing the directors with the nature of RF&P's assets and the company's business plan. However, if SHI is to become an effective vehicle for oversight, this relatively new board will have to give some attention to what information it regularly expects to receive from the president of RF&P to assist VRS with the proper discharge of its oversight responsibilities.

Reporting Requirements. As a company owning taxable raw land and developed properties, RF&P has to implement a strategy to create tax-free or competitive income yields for VRS. This will require careful tax planning, management of zoning issues, and the implementation of environmental clean-up activities. Understanding and evaluating the work of the company will require that a considerable amount of attention be given the overall management of the company and to the complex tax and development issues RF&P faces.

To facilitate proper oversight, SHI should establish a more formal standard reporting format for RF&P that requires the company to provide quarterly reports on the company's investment performance, real estate acquisition program, business plan, fiscal management, and personnel issues. The potential utility of this approach is outlined in Table 5. For example, RF&P's rental income and cash distribution status presented on a quarterly basis would summarize the performance of RF&P's rental properties and partnerships. A quarterly report on RF&P's real estate acquisition program would provide SHI with information on the type of properties the company is considering and what the likely cost of the investments would be.

Oversight of the company's fiscal management practices could be facilitated with a budget and year-to-date expense report. Also, regular progress reports on the status of the business plan would provide SHI with the updates it needs to successfully evaluate and report on RF&P's progress in this key area. Clearly, if the VRS did not

Table 5

Overseeing RF&P's Investment Performance: Suggested Reporting Requirements For RF&P

Report	Information Provided	Utility For SHI
Selected Cash Flow Statements	-Rental Income -Partnership Distributions	-Evaluate RF&P's Financial Performance
Real Estate Acquisitions	-Nature of Planned Acquisitions -Projected Costs of Planned Acquisitions -Nature and Costs of Completed Transactions	-Evaluate Direction of RF&P's Real Estate Acquisition Program
Progress Report On Business Plan	-Status on Resolution of Tax Issues -Status on Zoning and Environmental Issues -Status on Development Projects -Status on Land Sales	-Evaluate Progress RF&P Is Making On Implementation of Business Plan
Company Budget and Expense Report	-Staff Labor Costs -Consultant Expenses -Staff Expenses -Personnel Issues	-Evaluate RF&P Fiscal and Staff Management Practices

Source:

delegate this responsibility to an independent and knowledgeable board, it is unlikely that it would be able to give the RF&P investment appropriate attention without adversely affecting the amount of time it currently spends directing the investment activities of the entire fund.

Recommendation (1). **The board of directors for System Holdings Incorporated should establish a formal quarterly reporting requirement for RF&P which uses a standard reporting format to oversee the company's performance. This format should request information on RF&P's cash flow including partnership distributions, its real estate acquisition program, a progress report on the status of the business plan, and a report on the company's budget and actual expenditures.**

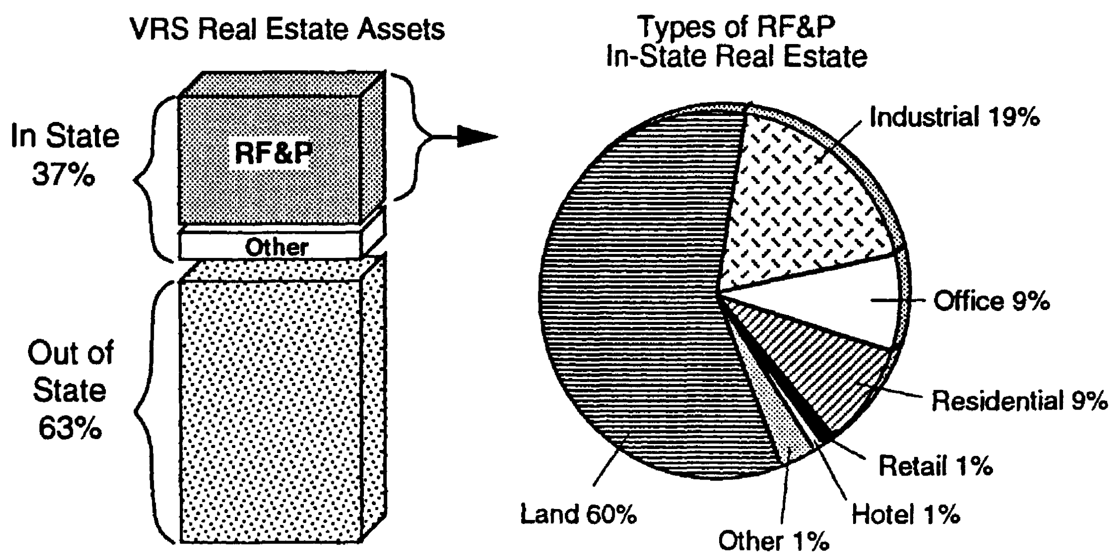
Oversight of RF&P's Real Estate Acquisitions. Although RF&P is the largest single real estate investment that VRS has ever made, the agency's total portfolio as of July 31, 1993, was approximately $900 million. In making real estate acquisitions, one goal of VRS is to diversify within this asset class in order to avoid large investment losses. To that end, VRS hired the Prudential Realty Group to conduct an analysis of its portfolio and recommend a program of diversification to guide the future investment of its real estate.

As a part of its analysis, Prudential identified several factors on which the portfolio should be diversified, established a numerical range identifying the proportion of real estate assets that should be invested across each of these factors, and compared this to VRS' actual real estate investment patterns. Among the critical factors were economic (geographic) location and property type. With the acquisition of RF&P, 37 percent of VRS real estate investments are in Virginia (Figure 15). When these holdings are separated by type of property, the analysis shows that VRS' portfolio is now heavily weighted with undeveloped land (60 percent), contrary to the Prudential asset allocation plan.

More importantly, as a private real estate company, RF&P has its own real estate acquisition program that will be implemented apart from the activities of VRS' Real Estate Advisory Committee. This situation raises important governance questions related to VRS management of the RF&P asset. As fiduciaries for the pension fund, VRS clearly has the responsibility to expect that its policy views regarding investment decisionmaking be reflected in the investment activities of its real estate managers. Out

Figure 15

Impact of RF&P's Assets on VRS' Real Estate Portfolio



Source: Virginia Retirement System.

of concern for this, one VRS Board member has suggested that the operations of RF&P be placed under the supervision of VRS' Real Estate Advisory Committee.

However, RF&P is a private corporation specializing in the management and acquisition of real estate. It has its own board of directors who, by State law, are vested with exclusive powers to manage the operations of RF&P. As the following statements from the corporate legal consultant for this study indicates, some care must be exercised in discharging oversight with respect to the investment activities of RF&P:

> A more cautious approach is indicated in discharging the Board's [VRS'] oversight with respect to . . . insuring that the business of RF&P is conducted in a financially prudent manner so as to assure a rate of return commensurate with the investment risk. Neither the Board nor SHI can retain a right to dictate specific investment plans or proposals (other than those extraordinary transactions requiring shareholder approval under the statute) . . . .

This conclusion appears to argue against a plan to formally coordinate VRS real estate activities with those of RF&P through the use of VRS' asset allocation plan. If, as a private company, RF&P's were forced to restrict its real estate activities through a plan imposed on the company by either SHI or VRS, both the appearance and reality of separate identities between these entities could be lost.

These restrictions do not, however, prevent VRS from exercising the required oversight for this investment. As SHI's parent company, the VRS Board can insist on a regular accounting of RF&P's performance including its real estate acquisition activities. Similarly, SHI can insist upon a regular accounting by RF&P directors and management. A major part of this accounting should be an evaluation of the type of real estate the company is acquiring and the rates of return produced by these assets.

If SHI finds that RF&P's management is consistently acquiring sub-par real estate and wishes to make changes in the RF&P board, it can do so. The only obligation of SHI in this situation is to consult with the VRS Board on its plans for addressing the perceived problem.

If, through SHI, the VRS Board finds that RF&P management is consistently acquiring property which is not of institutional quality, its recourse is to replace its elected directors on the SHI Board who will, in turn, replace directors on the RF&P Board. Presumably, the new SHI and RF&P directors would be persons who understand and properly implement the policies of the VRS Board as expressed by SHI. Considering that the election and replacement of board members is the core prerogative of shareholders, the VRS Board can exercise this right without fear that it will be found to have impermissibly "dominated" or "controlled" the management of the corporation.

One way to avoid the necessity for this type of disruption in the oversight process, however, is to ensure that RF&P's board of directors and management are fully aware of VRS' standards and performance expectations. If a proactive strategy of oversight is properly implemented, the pension fund is not exposed to potential liabilities stemming from the operation of RF&P because the VRS Board has not explicitly prevented the company from independently executing its real estate development management program.

Perhaps the most effective method to ensure that RF&P's senior management is consistently apprised of the goals and objectives of VRS' real estate program is to place one member of the VRS Real Estate Advisory Committee on the RF&P board of directors. As one of two VRS representatives on the RF&P board, this member could articulate the real estate investment views of VRS to RF&P staff as they consider various acquisitions.

Recommendation (2). **The SHI board of directors should appoint a real estate professional or other qualified member of the VRS Real Estate Advisory Committee to one of the two seats reserved for VRS on the board of directors for RF&P. This member should have a full understanding of and be able to articulate VRS' real estate investment strategy.**

The Commonwealth and RF&P Will Have to Adapt to New Roles of Accountability

Considering RF&P's status as a private corporation with a culture that is substantially different from that in the public sector, both the State and RF&P will face significant challenges in managing this investment. From the standpoint of the Commonwealth, there has to be recognition of the fact that many State policies and procedures which govern the expenditure of public funds cannot be imposed on a private corporation. In fact, to ensure that VRS' return from the investment is maximized, the State should insist that the RF&P be managed in an apolitical, businesslike manner. On the other hand, the RF&P will have to recognize that some normal business practices will be unacceptable to a public shareholder.

Adjusting to Cultural Differences. Perhaps the most significant of the differences in the public and private sectors relates to personnel policies and compensation. The Virginia Personnel Act (VPA) establishes the framework of the State's personnel function. Through VPA, the State has developed a centralized administration system which establishes the principles that guide agency policies related to filling employment vacancies, granting promotions, implementing employee dismissals, and establishing a salary structure.

RF&P, on the other hand, presently operates according to personnel policies more typical of private corporations. Some of these policies were established before the VRS acquired the company. In addition, RF&P is now in the process of adopting new personnel policies which will be guided by the norms in the private sector. Relative to State practices, the company's policies are substantially different with regard to how it hires, pays, promotes, and fires its employees. In some cases, these policies are largely inconsistent with the standard practices of the public sector.

For example, salaries for any class of employees at the RF&P — executive staff, real estate managers, secretaries, fiscal staff — are, in some cases, substantially higher than equivalent positions in State government. In addition, RF&P presently uses a bonus program to reward employees for outstanding work, such as completing the acquisition of a high yielding real estate asset. In 1993, the largest bonus paid in the company was $15,000.

Another example of the differences that can occur across the two cultures is the use of employment contracts. In the case of the RF&P, some staff presently have employment contracts as a result of agreements made during the CSX merger attempt. These contracts prohibit management at RF&P from changing the job descriptions or removing these employees without sufficient cause.

All of these contracts expire in March of 1994. If management violates these contracts prior to that date, the employees must be paid an amount equal to two and one-half times their 1991 salaries, subject to certain IRS limits. The total potential cost of these contracts to the company exceeds $1 million.

Another major difference in the public and private culture relates to the statutorily mandated procurement process. When procuring contract services or purchasing equipment for more than $10,000, State agencies must use the procurement process to ensure competitive bidding.

Neither the RF&P, nor any corporation, is encumbered by this requirement, though many companies impose their internal requirements. In 1993, the company budgeted more than $1 million for the purchase of outside professional services. Generally, senior management in the various departments make decisions to hire specific expertise. In some cases, management will request the approval of the board of directors before securing certain services.

Whenever these decisions are made, however, the process does not resemble the procedures required by the State's procurement laws and policies. The following case example illustrates how the RF&P's process was implemented to secure legal services for a specific project.

> *Prior to a RF&P board meeting in Spring of 1993, the president of the company invited a lawyer to the board meeting and asked him to discuss the history on some of the complex zoning issues that RF&P faced in Northern Virginia. At the conclusion of the presentation, the board of directors decided that the company needed to consider the possibility of legal action if certain key issues could not be resolved. Based on his knowledge of the zoning issues and his relationship with the key decisionmakers in Northern Virginia, the president of RF&P recommended that the board hire the attorney who had just completed the presentation. After some discussion, the directors concurred and negotiated a fee of $225,000 with some performance incentives.*

Because RF&P is owned entirely by VRS, an important question is whether the State should establish a set of standards to govern the operations at RF&P similar to those presently used for State agencies. Recent amendments to the Freedom of

Information Act (FOIA) do in fact subject RF&P to what can be described as basic standards of conduct and public accountability. However, FOIA stops substantially short of establishing parameters to govern the internal operations of the company.

Because RF&P must compete for staff and the services of various professionals in the private sector, the imposition of external restrictions beyond the boundaries of FOIA would likely place the company at a competitive disadvantage in the market place. Moreover, RF&P executives and board members will not always seek consensus with State government officials before making decisions. In the real estate business, the new company will need to move fast or opportunities will be lost. This argues against the establishment of a separate set of policies, apart from those already required through FOIA.

Awareness of Public Standards of Accountability. While RF&P should not be subject to additional external restrictions, both the board of directors and senior management must recognize that the company has a special responsibility to operate in a prudent and efficient manner. Though not a government agency, the company needs to be sensitive to public perceptions and expectations regarding its decisionmaking and operations.

Because of its unique relationship with the Commonwealth of Virginia, RF&P's standard of accountability needs to be higher than the norm for other private corporations. For example, regardless of its performance as an investment for the pension fund, expenditures at RF&P will be especially scrutinized. Every dollar that the company spends will be perceived as money which could have been paid into the pension fund.

In light of this, the RF&P board needs to ensure that public accountability becomes an important part of the organizational culture at the RF&P. An example of how this emphasis could alter company practices relates to employee expenses. Since becoming a real estate company, RF&P has typically budgeted about 15 percent of its total general and administrative operating expenses to employee expenses. In 1993, for example, this amounted to $145,000. Considering the nature of its business — managing and acquiring real estate — this does not appear to be an unreasonable expense.

However, a review of employee expense records indicates that some of the reported expenses could have clearly been avoided. For example, over a 12 month time period in 1992, one employee's expenses reached $30,000. Most of these expenses were lodging costs incurred by the employee as a temporary resident in a Richmond hotel. Other expenses paid for this employee during this time included airfare for trips made to his out-of-state residence, and valet parking service at the hotel.

According to management at RF&P, this arrangement was made because of the difficulty the employee had selling his out-of-state home. While this may not be an inappropriate or unusual expense for the private sector, it does not meet the more stringent test of public accountability.

Another example of the need for RF&P to reevaluate the standards under which it operates relates to the issue of special compensation for RF&P board members.

According to the National Association of Corporate Directors, boards of directors will sometimes award special compensation to board members in recognition of extraordinary performance on a particular project.

In the case of the RF&P, the board of directors established a subcommittee to consider payment of special compensation to two members who worked on the negotiations for one of the company's special projects. However, one of these members refused such compensation and requested that the board rescind its earlier decision. As a result, the two board members received no special compensation.

According to this member, although this was an appropriate action for a private corporation, he recognized that it might be perceived as a conflict under public standards of accountability. This is the type of scrutiny which both the RF&P board of directors and senior management will have to consistently bring to bear on future decisions at the RF&P.

Recommendation (3). **The RF&P board of directors should consider the development of "accountability guidelines" and "standards of conduct" for the board and staff, recognizing the company's unique relationship with the Commonwealth of Virginia.**

DEVELOPMENT OF RF&P'S BUSINESS PLAN

Since VRS acquired RF&P in 1991, a significant amount of the work of the company has been focused on developing and implementing a business plan designed to make RF&P a cash yielding vehicle for the pension fund. The business plan outlines RF&P's strategy for developing its raw land, resolving various zoning and environmental clean-up issues, and managing the development costs of Potomac Yard. Based on a review of the work conducted by RF&P staff, the consultants used by JLARC for this study have concluded that the plan is comprehensive, has feasible goals, and can probably be successfully implemented with considerable patience and skill.

This section of the chapter provides an overview of RF&P's business plan. This is followed by an assessment of some of the internal organization and management issues RF&P faces as it prepares for implementation of the plan.

Business Plan Addresses Key Issues Related to Development of RF&P

In 1992, management at RF&P indicated that the company's new mission as a real estate company would be to function as an asset manager with a goal of maximizing returns for VRS. Before establishing a strategy to fulfill this mission, some consideration had to be given to the issue of how RF&P's assets could be fit into the framework of a pension fund portfolio.

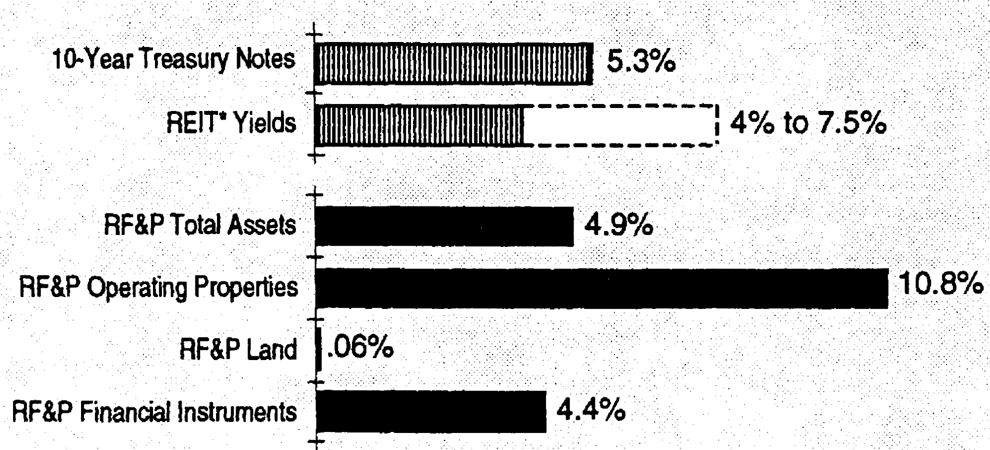
To accomplish this, officials from the company had to address three primary questions. First, because RF&P owns valuable, but undeveloped land, what approach should be established to realize value for the pension fund? Second, what timetables should be used for the development of the company's most valuable parcels given the anticipated zoning problems and development costs? Third, since RF&P is owned by a tax exempt entity but remains taxable as a private corporation, how can the income earned from the company's assets be passed through to VRS on a tax-free basis?

Framework for Realizing Value. As noted throughout this report, RF&P's most valuable assets include high quality operating properties which produce approximately $20 million in pre-tax income as well as undeveloped land that, in some cases, currently has a negative cash flow. While the rationale for holding income-producing properties as a pension fund asset is clear, the same can not be said for the ownership of undeveloped land. Without the benefit of immediate investment income, the value of undeveloped properties as a pension fund asset is not immediately obvious.

The president of RF&P indicates that the company's business plan views its income-producing properties as stand alone assets, possibly to be organized in a separate subsidiary corporation for the purpose of distributing cash flow to VRS. Using eight months worth of data from 1993, company officials compared RF&P's performance for its operating properties, including recent acquisitions, to the yields paid by 10 year US. treasury notes, and pension fund REITs (Figure 16). Based on this analysis, they concluded that RF&P's income-producing properties are in a position to distribute cash flow to VRS at a level which would establish these properties as top quality pension fund assets.

Figure 16

Comparison of RF&P's Real Estate Returns to Selected Benchmarks, 1993



*Real Estate Investment Trusts

Note: Yields for RF&P are based on eight months with four projected.

Source: The RF&P Corporation.

For its undeveloped holdings, RF&P's business plan outlines a different strategy. In light of the value of its principal land holdings, RF&P staff indicate that these properties should be developed mostly through land lease type agreements. The properties which have been cited for development either in part or in total over the next five years are the Arlington portion of Potomac Yard, Potomac Greens (which is adjacent to Potomac Yard), and Slaters Lane. The development portion of central Potomac Yard is projected to take 15 or 20 years to complete.

To determine what these properties are worth based on the existing or projected development rights, RF&P staff multiplied the market price for these parcels of land in today's market (based on comparable sales analysis) by the amount of RF&P's development rights for the properties. For example, if the market value for a commercially developed property was $10 per square foot and the development rights were for 100 square feet of commercial space, the "spot price" for the land would be $1,000.

RF&P estimates the "spot prices" for the Arlington portion of Potomac Yard, Potomac Greens, and Slaters Lane at approximately $150 million. The remainder of Potomac Yard, a much larger site, had a "spot value" of $220 million. Given the value of these properties and the potential upside associated with development of the land, RF&P staff point out that it makes economic sense to target these properties for development as a future income-producing asset for the Virginia Retirement System.

Value Versus Development Costs and Zoning Problems. The major premise underlying the land development aspect of RF&P's plan is that the value of its land and the expected appreciation in these properties is substantially higher than the costs to develop them. Moreover, the barriers to development — zoning problems, environmental clean-up costs — are formidable but manageable, with considerable progress already having been made. As a result, the company's business plan indicates that some of its key land assets can be converted to cash yielding assets for VRS in three to five years.

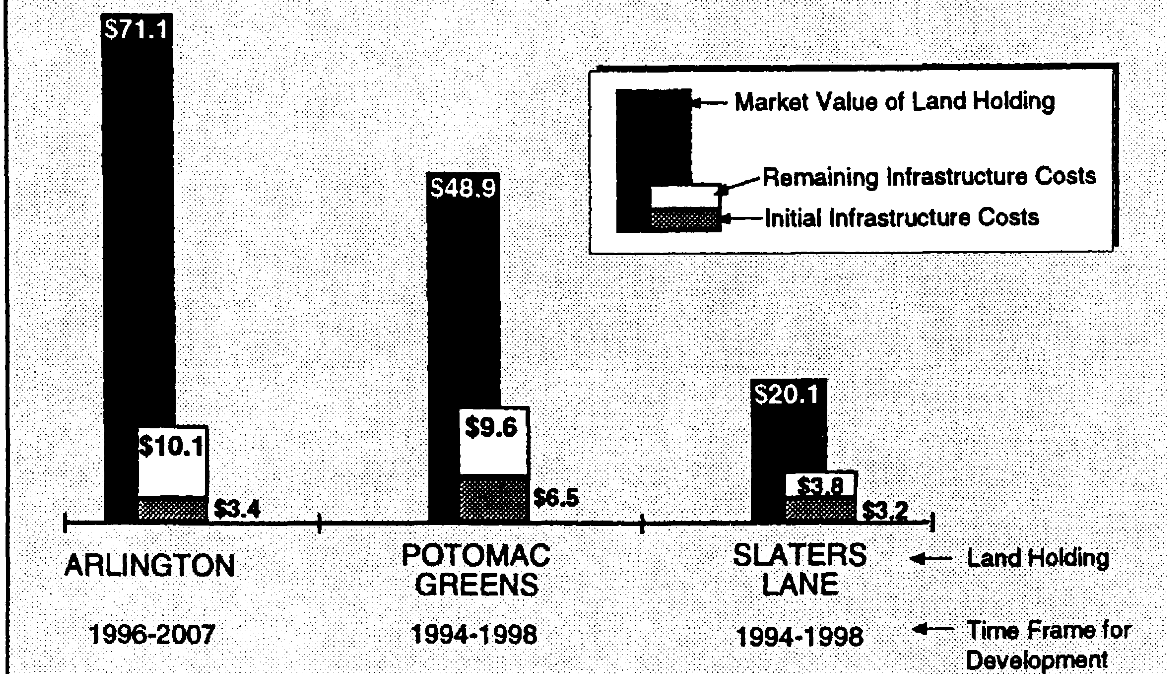
The projected start-up cost of key parcels of land which have been targeted for early development are shown in Figure 17. RF&P staff indicate that these infrastructure costs are determined based on reports from engineers who have inspected the sites and developed models to determine the cost based on the requirements of each site.

As indicated, the business plan suggests that three of RF&P's key properties could be developed in the near future — three to five years — with relatively little start-up costs compared to the value of the land. It is anticipated that the infrastructure costs for the largest portion of Potomac Yard will be extensive. Therefore, the plan is to finance the building of a Metrorail station to create demand for commercial and residential space and develop the rest of the site only when this demand materializes.

This strategy, it is estimated, will take 15 to 20 years to complete. In the interim, RF&P plans to use approximately 80 acres of the central Potomac Yard for smaller scale development which the company estimates will produce yields of $3.4 million to $13.9 million per year.

Figure 17

Development Costs and Timeframes for Selected RF&P Land Holdings (in $Millions)



Source: RF&P Corporation.

RF&P's business plan devotes considerable attention to strategies for resolving the various zoning and development disputes in which the company is involved in Northern Virginia. The plan acknowledges that several federal agencies have become major barriers to progress in the development of key areas of Potomac Yard.

Previous disputes with the County of Arlington and the City of Alexandria have been resolved. But, development based on these agreements cannot proceed without the cooperation of the relevant federal agencies. In view of this, the business plan indicates that RF&P plans to work with the officials from the localities and federal agencies for resolution of these disputes with RF&P (Table 6).

Taken together, RF&P's management states that the strategies outlined in the business plan leads to the following conclusions about the management of the company's land assets:

- Due to the high quality of RF&P's land assets, RF&P's land is generally at a point where realistic development plans can be made.

- With the exception of central Potomac Yard, RF&P's land assets, in general, can be developed with up-front costs that are small when compared to the value of the land.

Table 6

Status of RF&P's Zoning Disputes With Northern Virginia

Development Issue	Agreement	Next Steps
• Negotiate agreement with NPS to build an at-grade right-in, right-out entrance to George Washington Memorial Parkway	No	• Continue negotiations with NPS officials using support from Alexandria officials who favor the at-grade interchange
• Site plan approval with Alexandria for development of residential housing on Potomac Greens	No	• Work with Alexandria officials to resolve the interchange issue
• Settlement of dispute with NPS for approval of Port Potomac development plans	No	• Continue negotiations with support of Arlington County officials
• Settlement with airports authority on compensation for condemned land	No	• Currently in litigation
• Agreement with Arlington for additional one million square feet of density for Port Potomac	Yes	• Resolution of dispute with NPS and airports authority

Source: RF&P Business Plan, 1993.

- These land assets should begin generating material cash flow in three to five years.
- On the most valuable land holdings, it should be possible to create extremely high quality, long-term yielding assets.

Creating Tax-Free Income for VRS. The final issue addressed by the RF&P's business plan relates to its strategies to minimize the impact of federal and state income taxes on the cash flow which will be distributed to VRS. Currently, as a private "C" corporation, RF&P is subject to a 38 percent tax on its net income. Although the company is wholly-owned by a tax-exempt entity, under the company's current structure, RF&P's pre-tax cash flow cannot be distributed directly to VRS.

Simply put, this means that all income distributions that RF&P makes to VRS will be reduced by 38 cents on every dollar. For example, in 1991 the Crystal City development project yielded a pretax income of almost $14.5 million — a 13.52 percent rate of return. After business expenses, the company's net income from this investment was $13.6 million. When the federal corporate tax rate was applied to this amount, the after tax investment yield was reduced to $8.4 million, or about 8.39 percent.

RF&P's business plan provides a general and conceptual discussion of the company's future plans for minimizing the impact of the taxes on any distributions to the VRS. Basically, the company is in the process of evaluating two approaches. The first would involve the formation of partnerships to develop some of its raw land. The second would involve transforming the RF&P Corporation into a real estate investment trust. Conversion of income-producing property to REIT status would avoid income taxes of $4 to $5 million annually and require distribution of 90 percent of the profits to SHI.

The goal of transferring income to VRS essentially tax-free is more easily achieved if RF&P's deferred tax liability is eliminated. Still, even if is not, the JLARC tax consultants indicate there are other possible strategies, including the partnerships that VRS is considering, which could achieve the same objectives. These strategies, however, will be considerably more difficult. A more detailed discussion of RF&P's tax liabilities and RF&P plans for minimizing their impact is analyzed in the JLARC tax consultant's report, *Corporate and Tax Issues in the Acquisition of the Stock of RF&P Corp. by the Virginia Retirement System*. The JLARC real estate panel also examined the business plan and while this group expressed some reservations about RF&P's time frame for developing Potomac Yard, they generally found the plan to be reasonable.

The next section of this chapter discusses some of the organizational and management issues which will need attention if the company is to successfully carry out its business plan.

ORGANIZATION AND MANAGEMENT OF RF&P

Although RF&P appears to have established a sound business strategy for the management of its assets, this plan creates special challenges for the company. In order to execute this plan, both the RF&P board of directors and the company's senior management will have to resolve a number of organization and management problems within the corporation.

In the new RF&P, each of the company's departments have been redefined to accommodate the corporation's new mission. However, at times RF&P's progress towards fulfilling its new mission has been frustrated by some of the company's tradition-bound employees who have resisted change.

More importantly, attempts by the president of RF&P to reorganize the company around its new mission have been blocked by staff employment contracts which sharply limit any changes in the job functions of virtually all of the company's senior vice-presidents.

Largely as a result of these limitations, the president has implemented a less traditional style of management and hired new staff and a consultant to work in key positions within the company. While this approach has produced significant progress on the work for the business plan, it has also created inefficiencies in the company's operations, and was not properly communicated to other staff in the organization. This has created confusion concerning reporting relationships, slowed work on basic administrative issues, and fostered some dissension among company employees.

Further, as an organization, RF&P has not adjusted to the disruptions in the company that were created by CSX's attempted merger and the later acquisition by VRS. Contributing to this sense of instability is the fact that after two years, the company's president is still serving on an interim, part-time basis.

Conversion of RF&P to a Real Estate Company Redefined the Company's Mission

When VRS purchased sole ownership of the RF&P in October of 1991, a 156 year old railroad company was immediately converted to a real estate company. The impact of this change on the basic mission and activities of the company were substantial. Once dedicated to managing rail traffic and industrial real estate along its rail lines, the company had to be restructured to focus entirely on the acquisition of commercial real estate and the management of mixed-use development projects.

As a railroad, the company was a highly structured operation with the work organized along distinct functional lines — finance and administration, law, railroad operations, and real estate (Figure 18). The company's basic policy direction and business planning was conducted by a eight-member senior management team, including the company president. Each of the vice-presidents and directors in this policy group was also responsible for supervising the work of the employees in their relevant functional area.

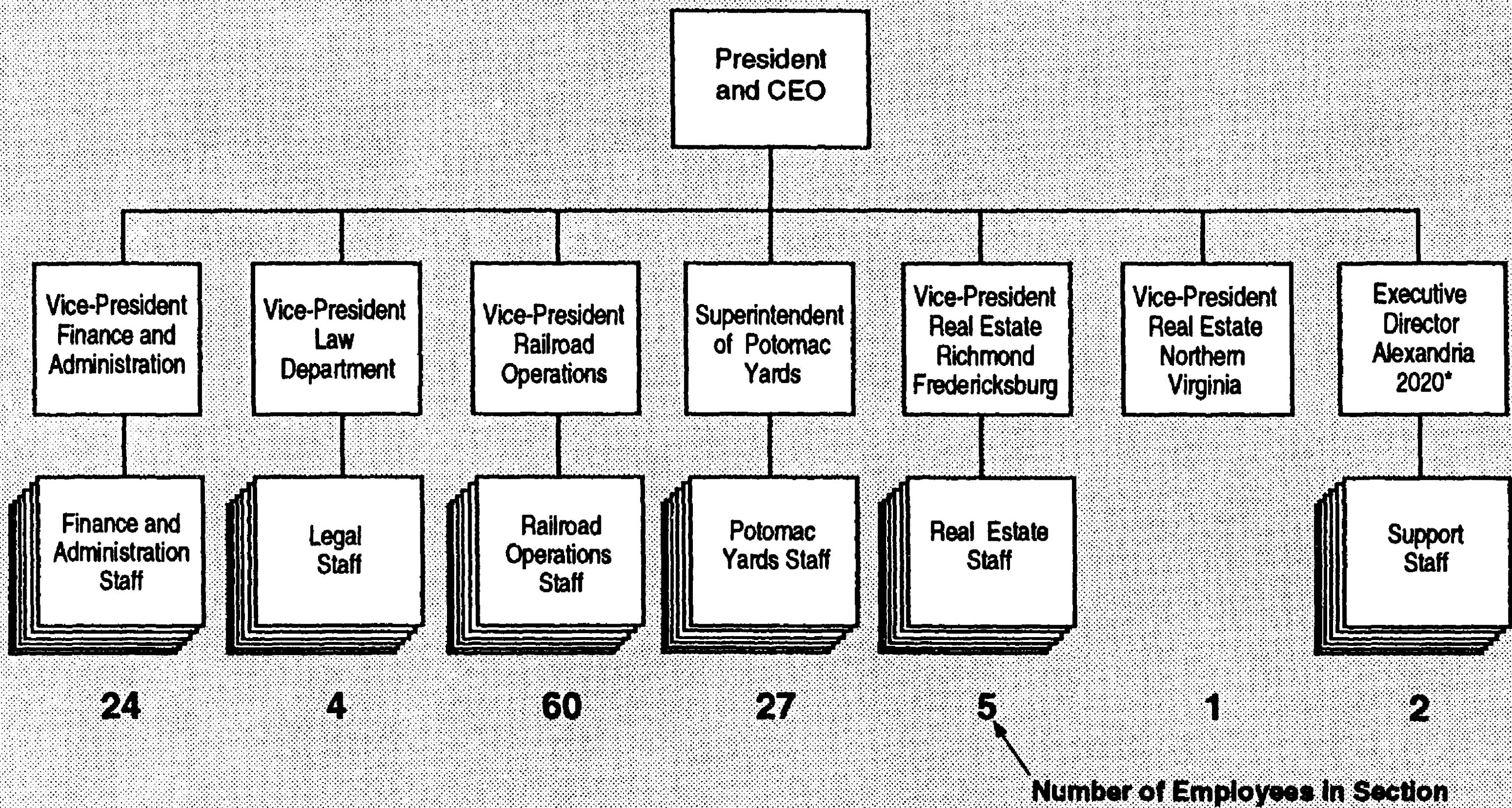
After the railroad assets for RF&P were sold to CSX, a significant number of the company's functions became immediately obsolete. Included among these were those functions performed by the vice president of operations and all of the departmental positions that were related to the operation of the railroad.

The impact of the acquisition on staff levels at RF&P should not be understated. Prior to VRS' purchase of this company, RF&P had 122 management positions, excluding the president. The largest number of employees (60) worked in railroad operations. After the acquisition, the entire company had only 19 employees — a decrease of 84 percent. The company now has 30 employees.

More significant than the initial loss of employees were the changes in the functional responsibilities for the departments which were not eliminated by VRS' acquisition of the company. For various reasons, important shifts in departmental responsibilities and related personnel duties took place in the real estate, finance, and

Figure 18

The Organizational Structure for RF&P Prior to the Acquisition



*Position reported to an executive committee

Source: RFP Corporation

legal departments. In addition, senior management created a Planning and Administrative Department to focus on strategic planning and human resource issues.

Changing Role of Real Estate Departments. As a railroad with a monopoly to operate along the Richmond-Washington corridor, RF&P was able to purchase large tracts of land adjacent to the right of way it was granted by the General Assembly. By the 1980s, the company's real estate interests had surpassed its railroad assets in terms of value. Despite this, for years the company did not establish an aggressive real estate management program and did not hire a professional real estate manager until 1981.

Most of company's real estate activities prior to this period were focused on industrial development projects linked specifically to the operation of the railroad. With these projects, the goal was to coordinate real estate development with rail service so that freight could be delivered to railroad customers in the most efficient manner.

For some of its more valuable parcels, the basic philosophy of the company was to hold its land assets, allow them to appreciate, and wait until management was approached by a developer with the skills to convert the land into a cash yielding asset for the company. This was the strategy used to develop the land in Crystal City in 1963. Obviously, after VRS acquired RF&P and converted it to a real estate company, the emphasis on a more aggressive and sophisticated management of the company's real estate interests became a paramount concern of the company.

This new mission for real estate managers has manifested itself in three ways:

- Most of the company's real estate managers must now aggressively seek out new acquisitions which meet the criteria for institutional quality property and perform the financial analysis required to evaluate the potential acquisition.

- Managers are expected to take the principal undeveloped land that the company owns through the various stages of land development to increase its value and prepare it for development.

- Managers are expected to conduct the necessary quantitative analysis to understand the performance of RF&P's income-producing properties as well as employ rigorous modeling techniques to support planning on various development projects.

Changing Role of the Finance Department. Perhaps the most significant changes occurred in RF&P's Finance Department. Prior to the transaction, the Finance Department had 21 employees to perform the company's basic accounting and administrative functions. However, because most of the accounting functions performed by this department were tied to the railroad operations, there was a precipitous drop in the accounting staff when CSX acquired RF&P's railroad assets. Specifically, this department lost 19 of its 21 employees.

At the same time, with the company's heightened focus on real estate, a whole new set of demands were placed on this substantially smaller staff. For the first time, the Finance Department was required to develop numerous customized reports on the company's operating properties. These reports required staff to analyze the company's complex lease agreements and partnerships.

Also evident after the purchase was the fact that RF&P did not have a comprehensive review program to conduct internal evaluations of its major real estate partner in Crystal City. Therefore, the Finance Department was expected to develop a program to assess the quality of the accounting records maintained by this partner, perform reviews of this developer's methods for calculating ground rents to be paid RF&P, and conduct regular performance audits of the company's many leases.

For the first time, RF&P's Finance Department was also asked to develop a long range financial planning and budgeting program. With RF&P's transformation from a railroad to a real estate company, senior management indicated that it would look to the Finance Department for short- and long-term financial planning. These plans, which involved the development of mission statements, goals and objectives, future projections of staffing needs, capital expenditures, and long-range tax planning, were unlike any analysis work that this department had conducted prior to the acquisition.

Finally, in light of the nature of the acquisition, the company was required to keep three sets of books. For tax purposes, RF&P had to continue its reporting on the tax basis of the company's assets since VRS' purchase of the company was not a taxable acquisition. RF&P also had to maintain the historical basis of the assets and liabilities it retained after the acquisition. For financial reporting purposes, the company had to use "pushdown" accounting techniques to allow for the fact that a new accounting entity was created by the acquisition.

Changing Role of the Law Department. The Law Department under the old RF&P dealt with a number of issues, most of which were tied to the operation of the railroad. A significant portion of the legal work performed by this department was in the areas of personal injury claims from railroad employees, real estate closings, collection of past due freight bills, environmental liability, and various legal issues pertaining to the management of rail traffic.

With the new RF&P, the need for a continued focus on environmental issues has not substantially changed, especially given RF&P's ownership of undeveloped land and the associated liabilities. However, the company now faces a myriad of tax issues as it attempts to develop its real estate assets and distribute any income from its operating properties to VRS on a tax-free basis.

Much of the complexity associated with this work is linked to the company's two large deferred tax liabilities. As a result, legal staff will now have to play a central role in the planning and execution of the company's evolving business strategies and are looked upon to provide sound advice on tax-related issues.

Major Departments Have Not Adequately Adjusted to RF&P's New Mission

In the two years since the VRS acquired RF&P, the company's president has made a number of personnel decisions to facilitate the development and execution of the business plan. Among these were the following:

- the promotion of the company treasurer to vice-president of Finance and Administration;

- the promotion of four real estate directors to vice-presidents, and;

- the appointment of a vice-president of Planning and Administration.

Figure 19 illustrates the current organizational structure of RF&P and the salary costs for the restructured company as of December 1992. As indicated, the president has organized the work of staff according to the major functions of a real estate company — planning and administration, finance, law, and real estate.

As Figure 19 indicates, the total labor and fringe benefit costs for RF&P staff is slightly more than $2 million. The costs of the professional staff in each department ranges from six (Planning and Administration) to nine percent (all other departments).

According to most all accounts, none of the major departments within the RF&P — finance, legal, real estate — have completely adjusted to the company's new mission or the demands placed upon them by the president. For a number of reasons, the most serious performance problems appear to have occurred in the Finance Department. However, there have been deficiencies in the performance of the Law and Real Estate Departments as well.

In some cases, the problems experienced by RF&P are to be expected given the disruptive nature of the attempted merger by CSX and the subsequent acquisition of the company by VRS. Still, in other cases, some staff appear to have been resistant to the new mission and direction of the company

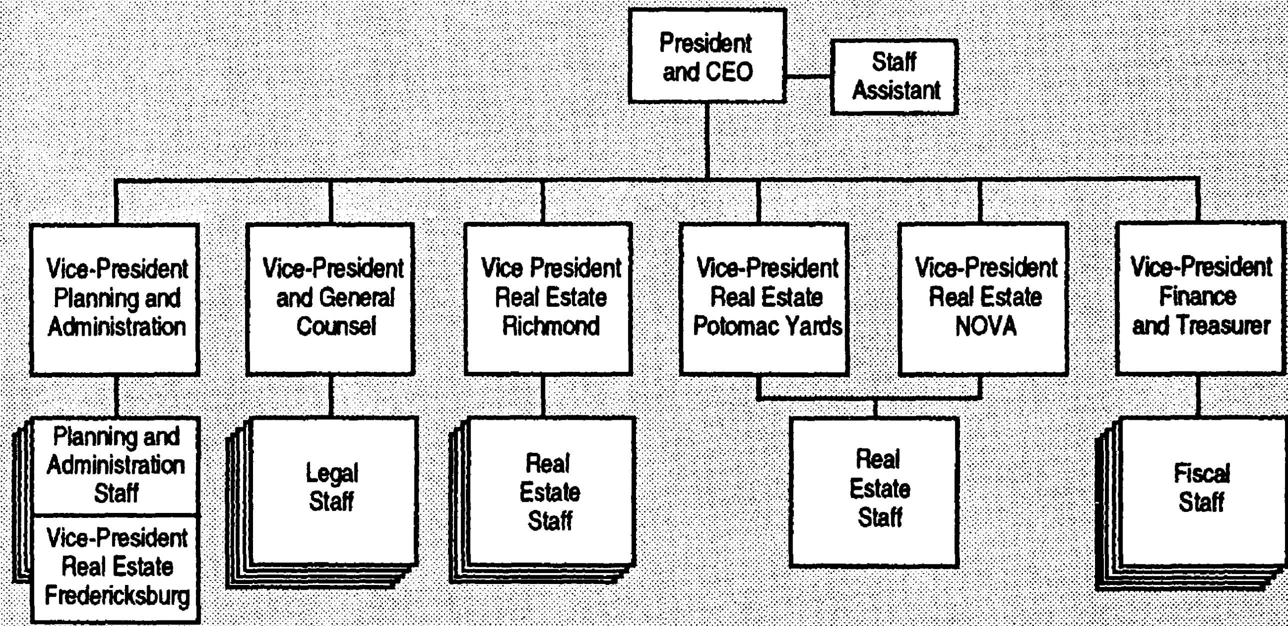
Problems in the Finance Department. In 1992, the independent auditor for RF&P completed its assessment of the Finance Department and raised a number of concerns. According to this review, one of the major problems with the department since 1991 has been its inability to provide senior management and the Board of Directors with timely reports on the performance of the company's key real estate properties.

The most important of these assets is the company's partnership in Crystal City. Before the acquisition of RF&P, management within the company reportedly paid little attention to the operation at Crystal City. After satisfying itself that the partnership was being properly run, there was no regular analysis of this asset.

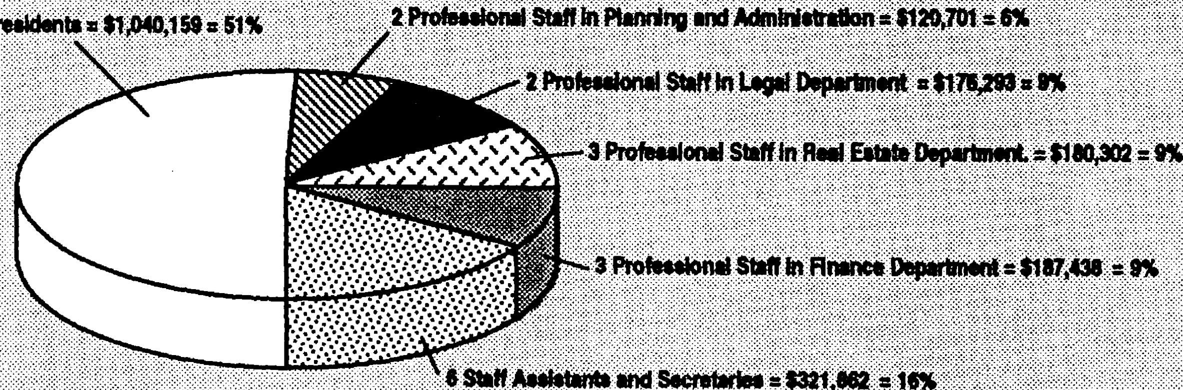
This philosophy was apparently carried over within the Finance Department after VRS acquired the RF&P. The vice-president of the Department contends that the

Figure 19

The Present Organizational Structure of RFP



Labor and Fringe Benefit Costs for RF&P Employees, 1992



Total Costs = $2,026,757

Source: RF&P Corporation.

normal cash flow statements provide a sufficient amount of information on these assets. The marginal benefits of customized reports he stated, are not sufficient to justify the amount of staff time it takes to collect the data and generate the reports.

This view differs sharply from those of the company's senior management staff and RF&P's auditor. These individuals state that without more detailed financial information on its Crystal City asset, the board of directors and senior management are unable to make timely and informed decisions. The following comments were made by one member of the senior management team.

> This [Crystal City] is one-half of the company's assets yet there is no capability in the company to perform a regular and useful analysis of this asset. The cash flow statements may be correct from an accounting perspective, but these type reports are of little use to management and the Board because they do not provide detailed information on the tenants and leases. Instead of addressing these type issues, the Vice-President of Finance prefers to focus on closing the books and nothing else.

Somewhat related to this is the absence of a regular comprehensive internal review of RF&P's partner in Crystal City. Because this project is so important as a revenue source for RF&P, the independent auditor points out that the Finance Department should have an established set of uniform procedures for evaluating the various lease agreements and partnerships that are associated with this project. Without this, it is not possible to regularly evaluate whether RF&P's interests in this partnership are always properly represented.

Professional staff in the Finance Department acknowledge that this type of review process has not been standardized. One employee noted that the oversight of Crystal City has been regularly and diligently performed by the vice-president, but indicated that the process he uses is "all in his head."

In addition to these problems, management within the Finance Department has been criticized for the following deficiencies:

- Failure to properly analyze and address the potential impact of staff reductions on the department's capacity to implement the necessary internal fiscal management controls;

- Failure to compensate for the increased reliance on fewer employees through cross-training;

- Failure to revise outdated policies and procedures manuals which govern the flow of work in the department;

- Insufficient assessment of staff skills, the impact of existing workloads, and changing company demands being placed on the department;

- Failure to complete the company financial statements in a timely fashion;
- Failure to document the basis for a number of critical accounting and reporting decisions;
- Use of inefficient methods for maintaining information on the historical value of RF&P's assets and liabilities which increased the time required for income tax reporting.

A central problem with this unit does appear to be a lack of staff and the unwillingness of the vice-president to focus on the resource issue. For example, the other professional staff in this department acknowledge that this unit has experienced some problems but attribute this to staff shortages. One staff member had this to say about the workload in his department.

> For the first year after the acquisition, if was just three of us in the entire Finance Department. We did all we could do to keep the wheels from coming off. Only those things which had to be completed were given any attention. Everything else was put on hold. However, with this approach, pretty soon things back up to the point where you are in a hole and some things simply do not get done. This is what happened in the department.

An independent audit report raised similar concerns.

> In previous years, the Finance Department relied on a staff [of 24] to handle the company's normally complex, ongoing accounting matters .... However, with the numerous changes that resulted from the spin-off and acquisition, the company reduced its Finance Department staff to four professionals. [These individuals] had to address several complex accounting, tax, and business issues.
>
> Although management and Finance Department personnel ultimately were able to accomplish their objectives in these areas, the company succeeded only with an unreasonable level of effort by its Finance Department and without the desired level of timeliness or review. This crisis mode can be and may have been effective in the short-term; however, it only rarely functions effectively in the longer term.

Despite these endorsements for more staff, the vice-president of the department does not share this view. He viewed the magnitude of the work as a "spike" in the Department's workload and rejected the notion that more staff were needed. Although two additional employees were hired during the course of this review, many of the other problems remain unaddressed. RF&P's auditor indicated that under current conditions, it could take "five or six years" before an acceptable level of progress is made in one of the most critically important departments within the company.

Problems in the Law Department. As noted earlier, the Law Department within RF&P experienced a substantial change in its mission when RF&P was converted to a real estate company. Most notably, the company faced a number of complex tax and environmental issues as it considered the possibilities for developing its assets and distributing income to its parent company, VRS, on a tax-free basis.

While the Law Department appears to have made considerable progress on assessing the scope and impact of the company's environmental liabilities, for almost six months after the transaction in October of 1991, the department did not play a proactive role in attempting to resolve some of the vexing tax issues. According to one member of RF&P's staff, for months after the acquisition, the Law Department failed to articulate a tax plan for the company.

> When I got here there was no tax plan. I found this troubling given the magnitude of the tax issues surrounding the company. We are a "C" Corporation wholly-owned by a tax exempt parent. There was talk of developing a plan to distribute income to the parent on a tax-free basis. No one in the Law Department or the company was addressing the impact of a complex 1988 restructuring.

Though an accelerated effort has since produced substantial progress in this area, successful resolution of some of the company's tax problems were unquestionably delayed by the Law Department's initial inaction.

Based on structured interviews conducted with RF&P staff, it appears that some of this lethargy was actually systemic in nature and based on the reactive role that the Law Department has traditionally played in company affairs. Specifically, this department has always viewed the company as its client. As such, staff in the department have perceived that the proper role is to wait for instructions before taking action.

Still, some of the slowness to react to this crucial issue appears to be related to a lack of communication regarding the company's expectations of the Law Department. According to senior management at RF&P, the vice-president of the Law Department should be regularly evaluating the legal needs of the company's business plan, assessing how much of the work can be done in house, and organizing and managing the purchase of the required amounts of outside expertise. When this does not happen, the staff within the Law Department have to take the lead on the assignments and work directly with the company's president to address both the tax and environmental issues associated with the implementation of the business plan.

However, for reasons that are not entirely clear, the vice-president of the Law Department has had no overall role in the implementation of the business plan. While two of his staff members are responsible for performing most of the in-house legal activities, the president of the company, with the assistance of these staff members, manages the implementation of both the contract and in-house legal work on the plan. This is not an adequate long-term solution to the problem that the Law Department has experienced in adjusting to its new role.

Problems with Real Estate Departments. A critical element in the future success of RF&P is the real estate vice-presidents. Each of the company's current real estate vice-presidents have been assigned a territory along the Richmond-Washington corridor. The JLARC real estate consultants spent considerable time with each of these vice-presidents during the course of this review and examined the company's plans for real estate through its business strategy.

The overall impression of the panel was that each vice-president appeared to be familiar with RF&P properties in their respective regions. However, the level of financial analysis skills among the vice-presidents was judged to be somewhat uneven. For two of the four vice-presidents, the panel concluded that some continuing education in this area may be beneficial. This is important because of the critical role that financial analysis has to play in the real estate vice-president's evaluation of potential acquisitions, the performance of existing holdings, and the management of undeveloped land.

An example of how shortcomings in this area can impact company operations was revealed by the questions raised concerning the possible loss of future income from the Crystal City project. During the course of the study, the US. Navy announced that it would be leaving Crystal City as a tenant in 1995. Because this is the anchor tenant for the entire development, there was immediate concern that RF&P would lose a substantial portion of its rental income when the move occurred.

However, company officials were not immediately able to address concerns about the potential impact of this move on company earnings because it did not have sufficient data from any of its real estate vice presidents to speak to this issue. This left the impression that the company lacked a basic understanding of the lease agreements that it had through its partnerships in Crystal City.

RF&P's senior management staff, indicate that the absence of quality information on the lease arrangements of the various tenants in Crystal City reflects the unwillingness or inability of some of its real estate staff to respond to the expanded role for these positions in the new RF&P.

This apparent problem has also impacted the company's real estate acquisition program. According to the JLARC real estate panel, one of the vice-presidents has no demonstrated experience in real estate development. Another has been involved only in smaller transactions. Based on the results of a similar assessment, RF&P management is considering moving away from a strict allocation of real estate assignments based on territory.

Employment Contracts Create Operational Inefficiencies within RF&P

As noted earlier, the current organizational structure for RF&P has only been slightly modified from the one used to manage the operations of the railroad. The basic premise of this approach is that the overall mission of the company creates sharp distinctions in the nature of the work required. Consequently, to avoid duplication, overlap, and general operational inefficiencies, major company functions should be departmentalized according to differences in the nature of the work.

While this traditional approach to organizational management has considerable merit, it imposes specific requirements on the senior level managers in the company. Most notably, this structure places a premium on the need to first identify the appropriate number of managers for the company and then ensure that they are actively engaged in the oversight and work in their departments.

If organizational functions are defined too narrowly, the company will have too many managers, thus reducing the likelihood that its mission can be efficiently accomplished. If some of the managers are not engaged in the work of their departments, implementation of the overall company business strategy can be frustrated.

Based on interviews with RF&P staff, it appears that several of the vice-presidents at the company are either completely or partially underutilized. Given the salaries that the RF&P pays its vice-presidents, this has created special problems in the efficiency of company operations. However, because some of these employees are secured by encumbering employment contracts, a reorganization of the company to address this problem would be costly.

Vice-Presidents' Work on Business Plan. Although RF&P employs seven vice-presidents in key functional areas of the department, several of these individuals have little or no role in the development and implementation of the business plan. In addition, one of these individuals is no longer involved in the management of his department. As the following comments indicate, most of these individuals suggest that they are being intentionally overlooked by senior management staff at RF&P:

> I have no overall consistent role in the implementation of the business plan. I am not a [title] and right now this is the skill they need. However, senior management has taken over the responsibility of managing the work within my department.

* * *

> The only time I get involved in the business plan is when senior management needs information to support a presentation to the board or JLARC. There is not sufficient staff involvement. There is absolutely no strategic planning that involves the vice-presidents as a group in this company.

* * *

> I have no role in the process and it has not been explained to me why I do not have a role. I am of the opinion that a core group runs the company and everyone else just hangs on.

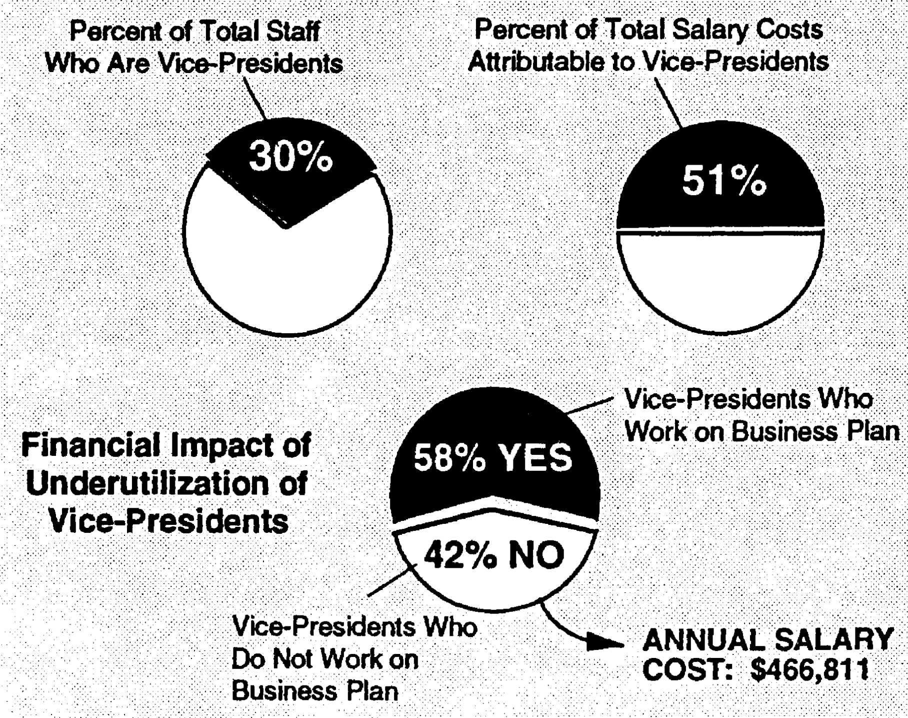
The value that RF&P places on the expertise of the vice-presidents is illustrated by the disproportionate share of the labor and fringe costs which are allocated to these positions (Figure 20). Although they represented only 30 percent of the company's employees (excluding the president) in 1992, the salaries and fringe benefits for the seven vice-presidents at RF&P represented over 50 percent of the company's total labor costs.

In light of this, the impact of under utilizing 42 percent of the company's vice-presidents is substantial. The total salary and fringe benefit costs for the three vice-presidents who indicated that they have little to no role in the company's current operations is more than $466,000. The costs of under-utilization for these positions are exacerbated by the fact that RF&P's senior management has on several occasions procured the services of outside consultants to perform some of the work which should be conducted by these vice-presidents.

Senior management recognizes these problems but has not been able to develop any effective solutions because of the stringent limitations imposed on RF&P by the employment contracts. Specifically, these contracts have been interpreted as restricting

Figure 20

Salary and Fringe Benefit Costs for RF&P's Vice-Presidents



Note: The role of each vice-president in both the development and implementation of the company's business plan was determined based on interviews by JLARC staff.

Source: RF&P Corporation.

RF&P from instituting retraining programs to prepare these employees for other duties, redesigning job descriptions, or reorganizing the company in a manner that would better match employee job functions with job skills.

As discussed in Chapter II, if RF&P violates these contracts it must pay the relevant employees amounts that equal two and one-half times their salaries, subject to IRS limits. According to the JLARC real estate panel, unless this problem is resolved, it is likely that this will frustrate the implementation of the new corporate mission.

Management Style Not Accepted by Staff, Administrative Issues Not Addressed

When the new management was installed at RF&P in 1991, the company lacked internal operating procedures, had an insufficient number of staff, and was faced with the pressing demand to develop a strategic plan for the management of its assets. So as not to be inhibited by the limitations of existing departments and the railroad-related skills of some staff, the president of the company responded by forming teams to complete specific tasks based on the particular needs of individual projects.

When the work of a company is organized in specific departments within an organizational hierarchy, as it has traditionally been at RF&P, expectations with regard to the chain of command are created. If the explicit chain of command is disrupted or ignored as a matter of course, organizational problems can and usually do surface in the form of staff discontent. The disadvantage, however, of consistently working within the hierarchical structure of a company is that efficiency in the work process will sometimes be sacrificed to the bureaucratic norms regulating both flow of communication and staff activities.

When working in this type environment, executive managers must attempt to strike a balance between accomplishing work in the most expedient fashion and respecting the organizational parameters of company. More importantly, if the decision is made to operate outside of the hierarchy, there needs to be clear and sufficient communication to staff of why such actions are necessary.

Impact of a Project-Specific Approach. In terms of productivity, the strategy used by the president to organize the work has served RF&P quite well. After a slow start on evaluating its tax questions and developing a strategic plan, the company has developed a business plan, presented it to VRS, and is now prepared to submit a ruling request to the IRS that could eliminate one of its large deferred tax liabilities.

On zoning issues, the company has developed agreements with two localities in Northern Virginia to end several years of negotiation and disagreements and appears ready to end its protracted disputes with two federal agencies. Similar progress has been made on some of the environmental issues the company faces, particularly in the case of Potomac Yard.

These are important accomplishments for a company that is in the process of being reorganized. However, in accomplishing these objectives the president failed to adequately communicate his management style and objectives to key staff members. As a result, many of the RF&P staff members did not understand his motives for circumventing the hierarchy and have expressed disappointment over what they perceive as an attempt by the president "to push some staff" out of the company.

Even staff members who understand and agree with his reasons, suggest that the president's management style has caused some problems, in part, because it was not adequately communicated to staff. Some of the comments provided by different staff on this issue are as follows:

> The president is product rather than process-oriented. Part of this is his background. He is an investment banker and is not accustomed to the institutional style of management. This has caused considerable tension and some dissension. The president's style has, on the other hand, allowed us to accomplish some things faster than we would have given all of the turmoil surrounding the acquisition. The problem is that it was not communicated so some people were not signed on. This management approach is not healthy in the long run.
>
> * * *
>
> Since the transaction I have had no direction at all from the [president]. I have no idea what he expects. I have tried to meet with him but it has not happened. The president is a hands on manager but has not explained to me what my role is. My staff take their assignments from the president and he makes the decisions about how work will be distributed in my department.
>
> * * *
>
> I am not sure how the organization works anymore. All I know is that the president call all the shots. He prefers to have a small group of people working on their own.
>
> * * *
>
> The president likes consensus management. I think he has surrounded himself with people he wants to work closely with. I still think the organization needs to reestablish a management committee to involve all of the senior staff in the planning and direction for the company.
>
> * * *
>
> The president is product-oriented. Sometimes he wants to [work around] non-performers. Other times he wants to work with people

who are familiar with the issue. The problem is that a lot of people are used to operating in a strict hierarchical structure.

Lack of Attention to Administrative Issues. When RF&P was a railroad, its corporate manual consisted of 43 executive orders which established the operating environment of the company. With VRS' acquisition of the company, six of these executive orders were made obsolete and a decision was made to revise the orders by creating a new corporate policy manual.

In January of 1992, the assignment for revising corporate policies was given to RF&P's corporate secretary. Two months later, the president hired a vice-president and put him in charge of a newly created department referred to as the Planning and Administration Department. The primary responsibilities of this new department were strategic planning for the company's business plan and human resource administration. The latter area includes insurance, risk management, office administration, pension planning, and health insurance.

Between March of 1992 and September of 1993, RF&P's corporate secretary did make progress in developing draft revisions to some of the company's old policies as well as formulating draft versions of new policies. However, most of the draft policies were not formalized and implemented by senior management. As a result, a year and a half after the process was initiated, the company has not developed a comprehensive set of policies to establish an operational framework for RF&P and distributed them to staff. For many employees, this has raised unnecessary questions about the stability of the company. More importantly, it has at times, produced inconsistencies in management practices. Specifically, at the time of this study, RF&P had yet to articulate the company's organizational structure and reporting relationships to all staff members, there was no formal employee evaluation system, company job descriptions were still not ready for dissemination, and revisions to existing policies on moving expenses or staff expenditure authority had not been completed.

The failure to articulate an organizational structure with staff reporting relationships is an important shortcoming. With the exception of a few individuals, the staff interviewed by JLARC had never seen the organizational chart and were unclear on the role of the vice-president of Planning and Administration. According to senior management, the vice-president of this department is in charge of personnel, human resource functions, and strategic planning for RF&P. As such he has authority over the other vice-presidents. However, only one of the vice-presidents interviewed by JLARC staff understood this relationship.

The absence of an employee evaluation system has also been a problem. Most of the staff interviewed had not been evaluated in more than a year. Some had never received a formal evaluation. Still others have been evaluated but they were not aware if it was considered a formal review. One staff member indicated that he was awarded a raise, but payroll never received notification, and he never got the promised increase in salary.

It appears that the primary reason that these organizational issues have not been addressed in a timely manner is the competing responsibilities of the vice-president of Planning and Administration. Although hired primarily to manage the administrative affairs of the company, the vice-president has spent a considerable amount of his time conducting asset and investment analysis, and acquiring and closing real estate deals in Northern Virginia and Richmond.

These duties are identified in the job description for the vice-president. Nonetheless, the decision to focus on this particular aspect of the job in light of the need to remedy some of the organizational problems that were caused by the VRS' acquisition is questionable and has probably been counterproductive to the company's transition.

Future Role for RF&P Staff in the Management of the Company's Assets

One question that has been consistently raised about the RF&P Corporation is whether its assets could be adequately managed through a model similar to that used by VRS' real estate division to manage its assets. In this model, VRS' asset managers hire companies to manage the leases on its buildings. When leases expire, the management company is expected to find replacement tenants.

For a number of reasons, this would not be a prudent approach for the management of RF&P's assets. First, RF&P owns a substantial amount of undeveloped land. Before this land will be converted to a cash yielding asset for VRS, a number of zoning and environmental issues will have to be resolved. This requires a staff that has the knowledge and time to devote to these issues, as well as an ongoing relationship with local officials who control zoning rights.

Second, and perhaps most important, if VRS is to receive an adequate return on this investment, RF&P's deferred tax liabilities must be expertly managed and coordinated with the company's overall plan to generate a tax free yield for the pension fund. By definition, management companies do not possess the expertise to deal with the complicated tax questions that RF&P will have to resolve over the next few years.

RF&P's executive management report that they are presently evaluating a number of strategies for improving internal operations. However, the changes which are being contemplated will likely be held in abeyance until a study of the company's job classification and compensation system is completed by the consulting firm of Hewitt Associates.

Some of the organizational changes that executive management and the RF&P board of directors should consider based on this review are as follows:

- The current organizational structure is not fully understood by staff. Executive management at RF&P should distribute a copy of the company's organizational chart to all staff with an accompanying discussion on lines of authority and reporting relationships for each department.

- The current organizational structure is top heavy. Greater efficiency and economies of scale can be achieved by reducing the number of senior vice-presidents.

- The skill requirements for real estate vice-president appears to have changed since RF&P was converted from a railroad to a real estate company. RF&P should implement a program of continuing education in financial real estate analysis for its vice-presidents on an as-needed basis.

- RF&P needs a strong administrator to organize and consistently manage company operations. These duties conflict with the demands of its real estate acquisition program. Consideration should be given to changing the responsibilities of the vice-president of Planning and Administration to focus more on internal operations and less on real estate acquisitions.

- The Finance Department is operating under considerable stress. RF&P should conduct a workload and staffing analysis and implement the necessary changes to ensure the department is able to successfully carry out its new role.

- RF&P's costs for support services — secretaries and staff assistants — appear high. The current class and compensation study in progress at the RF&P, should examine the potential for costs reductions in this area, giving appropriate attention to employee length of service and job duties.

Interim, Part-Time Status of President Has Created Instability

The current president of RF&P was originally hired by the company's board of directors on a temporary basis to assist in the search for a permanent chief executive officer. In organizing the search process, the board realized that RF&P did not have a clearly defined mission. More importantly, very little attention had been given to how the company would function as a pension fund asset.

Consequently, the RF&P board requested that the current president work with the company on an interim, part-time basis to develop a job description for the chief executive officer and a business plan to guide the future direction of the company.

In the two years in which the president has served in this part-time capacity, RF&P has made considerable progress. Largely as a result of the president's creative thinking and business knowledge, the company has defined its role as a pension fund asset and is now in a position to undertake the task of implementing a rather challenging business plan.

However, at this point, it appears that the company has moved past the stage from which it can further benefit from having a temporary, part-time president. As RF&P moves forward with the implementation of the business plan, the president of this company will be called on a daily basis to address issues related to zoning, commercial, and residential real estate development, corporate taxes, real estate acquisitions, real estate finance, and environmental liabilities.

Further, as the results of this review indicate, RF&P has a significant number of internal organization and management issues to address in the coming months. This will, in some cases, require an extended "hands-on" approach from the chief executive officer.

Finally, having a interim part-time president for over two years has in some ways added to the instability in the organization. RF&P employees who have expressed some concern about the company's future, attribute some of their anxiety to the fact that the company does not have a permanent president. For these staff, what may otherwise be viewed as routine organizational problems, engender more apprehension about the future of the company when the president is serving on an interim basis.

Recommendation (4). **The RF&P board of directors should begin the process to recruit and appoint a permanent, full-time president and chief executive officer for the RF&P.**

Continuity and Political Neutrality Will Be Important for the RF&P Board

As a private real estate company, wholly owned by the Commonwealth of Virginia, RF&P can anticipate a level of interest and scrutiny of its operations that will be unusual for a private corporation. This will be especially true for the policymaking arm of the company — the RF&P board of directors.

As stewards for the RF&P, both SHI and the VRS Board of Trustees need to exercise caution and good judgment in situations whenever it exercises the chief prerogative of a shareholder — the election and removal of board members. If this company is to succeed it is essential that VRS and SHI attempt to establish continuity in service for RF&P directors and work diligently to keep the appointment process free from the appearance of political interference or influence.

Establishing Continuity on the RF&P Board. The issue of turnover on the RF&P Board is critical because it can adversely impact public perceptions about the stability and credibility of the company, and can reduce a constantly changing board to a rubber-stamp operation for the RF&P staff. This is a particular concern in light of VRS' history in making appointments to the RF&P board (Table 7).

Since October 10, 1991, the RF&P board of directors has changed its membership five times. In virtually every case in which a change was made, with the exception of the resignation of CSX representatives, public attention was focused on the appointment process, raising questions about why certain members were leaving and why others were appointed.

Given the complexity of RF&P — development issues, tax considerations, and the business plan — the board of directors for the company will need to be fully informed

Table 7

Changes in the Membership of the RF&P Board of Directors Since the Acquisition by VRS

Date	Board Members Added	Board Members Resigning	Total Members On Board
September 27, 1990	2	0	14
October 10, 1991	2	12	4
November 20, 1991*	10	0	14
November 22, 1991	0	7	7
Nov-Dec 1992	4	0	11
February 9, 1993	0	2	9
Total	18	9	9

Source: RF&P Corporation.

*Required to comply with corporate formalities.

of company operations if it hopes to be effective in critically evaluating the actions and proposals of RF&P staff. In addition, the strategic issues facing the company will require long-term solutions in which the board will need to be involved. Constant turnover in board membership will not be conducive to long-range planning.

The current RF&P board has served as a group since December, 1992. During the course of this study, a solid core of members on the board of directors has met with staff on a monthly basis in meetings that typically last all day. At these meetings the board had to consider and vote on a company business plan, legal strategies for seeking certain development rights in Northern Virginia, and staff's proposals to purchase properties which cost from $20 million to $36 million. If the Board were constantly changing, this level of stewardship could not be provided.

Non-Political Appointments. One of the most significant challenges that VRS faces in managing this investment is how to keep it free from political interference. In normal circumstances under which shareholders elect directors of corporations, political interference in the selection process is not a concern. However, because RF&P is owned by an agency of State government, there will be a natural tendency for many to blur the distinction between RF&P as a private corporation versus RF&P as an agent of State government.

In such cases, VRS may be subject to some pressure to accommodate specific political interests when making board appointments. To avoid this problem, VRS and SHI must ensure that future appointments are apolitical and based on a candidate's real estate expertise or business acumen.

Further, SHI will also have to consider the advisability of appointing individuals who meet these criteria but are nonetheless politically active at the State or local level. One of the most significant threats to the future of the company will be if its board fails to avoid politics and bases its decisions on political concerns rather than the interests of the RF&P and the Virginia Retirement System.

Recommendation (5). **The board of directors of System Holdings, Inc. should establish written qualifications for appointments to the RF&P Corporation's board of directors. The criteria for appointment should be based on clearly demonstrated expertise in real estate management, investment, finance, or business management.**

THE FUTURE OF THE PENSION FUND'S INVESTMENT IN RF&P

As noted in the discussion of RF&P's real estate portfolio, approximately 43 percent of its assets are undeveloped land. Although this land has considerable value and development potential, there is some risk associated with holding such assets for future development. Under the current structure for this investment, the VRS assumes all of this risk because it owns 100 percent of the company. Should the VRS Board of Trustees determine that such an ownership position is inappropriate for the retirement system over the long term, it should be careful to reduce its interest in the company based on sound economic analysis and in ways which protect VRS' remaining investment in the RF&P.

There are perhaps many ways in which VRS could reduce its ownership position. VRS should fully evaluate alternatives such as partnerships, the sale of RF&P stock, or the conversion of RF&P operating properties into real estate investment trusts (REITs). Some of these options are already under consideration by the management of the RF&P as ways to distribute tax-free yields to the VRS. Such options also help to reduce the retirement system's risk in the investment.

However, it is also essential that VRS fully evaluate the extent to which sharing the risks of the investment will result in a sharing of the investment income from successful development of RF&P properties. A decision to reduce the Virginia Retirement System's interest in the RF&P, therefore, must be based on sound investment analysis which weighs the reduction of risks against the loss of potential future yields. In acting on such analysis, the Board can ensure that it represents the best interests of the members and beneficiaries of the Virginia Retirement System.

Recommendation (6). **The Virginia Retirement System should evaluate the appropriateness of its sole ownership of the RF&P Corporation. If some reduction of VRS' interest is considered prudent by the Board, it should carefully evaluate alternatives to ensure that the remaining investment in the RF&P Corporation is not jeopardized.**

Regardless of the eventual ownership position which VRS may take in the company, the consultants for this study have concluded that VRS should not find it necessary to provide any financing for the development of the RF&P properties. According to the consultants, RF&P should seek necessary financing from conventional lending sources such as contributions from partnerships or borrowing from commercial banks. It would be imprudent for VRS to finance development in any case for which funding cannot be competitively secured from such conventional sources.

Recommendation (7). **The Virginia Retirement System should, in keeping with current policy, provide no funding for the development of RF&P land holdings. Financing for the development of the properties should be secured only through conventional sources.**

Appendix A

House Joint Resolution No. 392
1993 Session

Requesting the Joint Legislative Audit and Review Commission to study the structure and investment policy of the Virginia Retirement System.

WHEREAS, Article X, Section 11 of the Constitution of Virginia requires the General Assembly to maintain a state employees retirement system to be administered in the best interest of the beneficiaries and subject to the restrictions and conditions prescribed by the General Assembly; and

WHEREAS, the Virginia Retirement System holds assets in excess of $14 billion and provides retirement benefits for thousands of retired state employees, local government employees, public school teachers, and state and local law enforcement officers; and

WHEREAS, the Virginia Retirement System is administered by a Board of Trustees which is solely responsible for administration of the system; and

WHEREAS, it is essential that members and participating employers have continued confidence in the ability of the Virginia Retirement System to properly manage assets to ensure adequate funding for retirement benefits; and

WHEREAS, concerns have been raised about the independence of the Virginia Retirement System and about the soundness of investments made on its behalf; and

WHEREAS, the Joint Legislative Audit and Review Commission last completed a comprehensive review of the Virginia Retirement System in 1978; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Joint Legislative Audit and Review Commission be requested to conduct a study of the Virginia Retirement System, focusing on (i) the structure of the retirement system fund and alternative fund structures which will ensure its independence as a public trust; (ii) the structure and appointment of the Board of Trustees; (iii) the structure and appointment of the advisory committees on investments and real estate; (iv) the organizational relationships between the Virginia Retirement System and the subsidiary corporations created to manage assets and the appropriateness of the structure for the RF&P Corporation; (v) the soundness of investments, especially the acquisition and continuing ownership of the RF&P Corporation; and (vi) the actuarial soundness of the retirement system.

To assist the staff in this review, the Commission may employ any investment, real estate, or actuarial consulting services it deems necessary. Expenses for such services shall be partially funded from a separate appropriation for the Commission in the amount of $250,000. The Commission may request the participation of other members of the General Assembly and individuals knowledgeable in retirement systems in the conduct of this review.

The Virginia Retirement System shall make available to the Commission all information which shall be necessary for the completion of this review. The Auditor of Public Accounts shall provide assistance as requested by the Commission. The Commission shall complete its work in time to submit its recommendations to the Governor and the 1994 Session of the General Assembly as provided in the procedures of the Division of Automated Legislative Systems for the processing of legislative documents.

Appendix B

Agency Responses

As part of an extensive data validation process, the major agencies involved in a JLARC assessment effort are given an opportunity to comment on an exposure draft of the report. This appendix contains the RF&P Corporation's response to this report. Appropriate technical corrections resulting from the written comments have been made in this version of the report.

RF&P Corporation

Rory Riggs
President and Chief Executive Officer
Telephone No. (804) 225-1621
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November 5, 1993

Mr. Philip A. Leone
Director
Joint Legislative Audit & Review Commission
Suite 1100, General Assembly Building
Richmond, Virginia 23219

Dear Mr. Leone:

I would like to commend the staff members and consultants who prepared the reports on RF&P Corporation for the Joint Legislative Audit and Review Commission on their thoroughness and clarity. Their work provides a valuable tool not only for the General Assembly but for RF&P and the Virginia Retirement System.

As the reports show, RF&P is in a transition period from a railroad to a real estate company. Much has been done; much remains to be done. Let me assure you that you will see significant progress on our transformation in the near term and that this report will be a further catalyst in this regard.

We intend to circulate the JLARC recommendations to our employees, our board, the SHI board and VRS. We intend to make formal presentations to each group with respect to implementation of these recommendations. We will focus on and deal with these recommendations promptly and professionally.

I hope in the near future we might have an opportunity to report to JLARC on our progress. The RF&P is a very valuable asset for the VRS. The report, the process of its formulation and its recommendations have been of great assistance to the ultimate goal of making RF&P the best performing, long-term asset of the VRS. We hope through our response to your recommendations that you will realize that this is a goal we take very seriously.

Sincerely,

Rory Riggs

JLARC Staff

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Recent JLARC Reports

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Interim Report: Status of Part-Time Commonwealth's Attorneys, January 1989
Regulation and Provision of Child Day Care in Virginia, September 1989
1989 Report to the General Assembly, September 1989
Security Staffing in the Capitol Area, November 1989
Interim Report: Economic Development in Virginia, January 1990
Review of the Virginia Department of Workers' Compensation, February 1990
Technical Report: Statewide Staffing Standards for the Funding of Sheriffs, February 1990
Technical Report: Statewide Staffing Standards for the Funding of Commonwealth's Attorneys, March 1990
Technical Report: Statewide Staffing Standards for the Funding of Clerks of Court, March 1990
Technical Report: Statewide Staffing Standards for the Funding of Financial Officers, April 1990
Funding of Constitutional Officers, May 1990
Special Report: The Lonesome Pine Regional Library System, September 1990
Review of the Virginia Community College System, September 1990
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State Funding of the Regional Vocational Educational Centers in Virginia, January 1991
Interim Report: State and Federal Mandates on Local Governments and Their Fiscal Impact, January 1991
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Catalog of Virginia's Economic Development Organizations and Programs, February 1991
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Catalog of State and Federal Mandates on Local Governments, February 1992
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Medicaid Asset Transfers and Estate Recovery, November 1992
Medicaid-Financed Hospital Services in Virginia, November 1992
Medicaid-Financed Long-Term Care Services in Virginia, December 1992
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