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The Public Utility Holding Company Problem

THE economic explanation for the existence of holding companies lies in the possibilities they offer for relatively larger profits.[1] The holding company allows greater scope in which to apply the financial principle of "trading on the equity";[2] it permits the control of any given aggregate of assets with a smaller investment than other means; and because of the foregoing it enables those who hold the ultimate control greatly to increase the percentage rate of return upon their own investment.[3] In the United States this device has been most fully developed in the public utility field which it has now come to dominate. During the early days of the electric power and light industry the problems of how to procure sufficient capital and efficient management were vitally important; the holding company device seemed to provide a working solution to both difficulties.[4] Furthermore, the earnings of properly managed operating companies, once well-established, tended to increase or remain relatively stable, and as a consequence they were ideal for the application of the principle of trading on the equity.

In recent years the public utility holding company has been widely criticized. Fortified by data uncovered by several important investigations[5] and by the dramatic failure of certain of the more complex and

[1] The economic reason for the existence of the holding company must be distinguished from the "economies" or advantages usually cited in behalf of it. The latter have been frequently summarized, and there is no need to repeat them here.

[2] Briefly, this principle is that if one can borrow capital at a lower rate than he can make it earn, the rate of return upon his own capital will be increased. Perhaps the best discussion of it is still to be found in LYON, CORPORATION FINANCE (1916) 50-82.

[3] Theoretically, the rate of return to the control group may be raised to almost any given figure; practically, limitations begin to appear rather early because of the inability to sell fixed return securities to outsiders after perhaps the fourth or fifth step in the pyramid. For an interesting and detailed illustration of the principle see *Control of Power Companies,* SEN. DOC. No. 213, 69th Cong. 2d Sess. (1927) 172-5.

[4] The present writer has discussed this elsewhere. Buchanan, *The Origin and Development of the Public Utility Holding Company* (1936) 44 J. POL. ECON. 31-53.

[5] Until 1928 there was relatively little criticism of the holding company system or the utility industry. The National Electric Light Association had carried on a

highly pyramided holding companies, writers and orators alike have vigorously condemned the device. In the following pages an effort will be made to appraise the weaknesses and abuses of the public utility holding company insofar as they may affect adversely (1) the interests of consumers of utility service, (2) the interests of investors or (3) the general welfare of the people at large.

I

HOLDING COMPANIES AND CONSUMERS OF UTILITY SERVICE

A holding company has power to determine the financial and management policies of the enterprises subsidiary to it. Where the subsidiaries are corporations selling utility services to the general public, the purchasers of such service have a right to demand that at all times the enterprises be operated with a due regard to their interests. That is, rates must not be higher than necessary because the operating company's expense account has been inflated, or because a weakened financial condition has resulted from unwarranted dividend disbursements. Paradoxically, consumers have been harmed by the holding company system because some expenses of the operating company have been too high while others have not been high enough. The expenses of the operating company have tended to be too high while it purchased something from its parent; but in calculating net income available for dividends on common stock there has been a tendency to understate certain operating expenses.

Many holding companies in the past have undertaken to provide their operating subsidiaries with various kinds of services on a fee basis. The nature of the services rendered has varied from system to system, but in general it has included general management supervision, engineering and construction supervision, and special miscellaneous services in-

most effective program of public relations which succeeded in submerging the few critics who ventured to express themselves. Perhaps the first critic to receive a respectful hearing was Professor Ripley with his MAIN STREET AND WALL STREET. Shortly thereafter the Senate ordered the Federal Trade Commission to consider the whole problem. The early disclosures of this study were so startling that several states undertook independent investigations of the holding company and its relation to public utility regulation; the more important of these were New York in 1930 and 1935, Massachusetts in 1930, and Pennsylvania in 1931.

The Federal Trade Commission's study ultimately ran to more than eighty volumes of hearings, exhibits and reports. These volumes have been published as SEN. DOC. No. 92, 70th Cong. 1st Sess. (1928) and will be referred to herein as UTILITY CORPORATIONS. Pursuant to H. RES. No. 59, 72d Cong. 1st Sess. (1932) and H. J. RES. No. 572, 72d Cong. 2d Sess. (1933), the House Committee on Interstate and Foreign Commerce has published a six volume study entitled, RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES IN POWER AND GAS AFFECTING CONTROL (1932-3). This will be hereafter referred to as RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES.

cluding auditing, appliance merchandising and special studies.[6] The official investigating bodies discovered that such contracts for services were the source of rather large and perhaps unwarranted profits to the holding companies providing them.

The determination of how profitable these servicing arrangements have actually been in the past presents certain problems. For most holding companies it is not possible to separate accurately the costs of rendering service from other expenses. Where the services have been rendered by a subsidiary wholly owned by the holding company, the holding company's investment therein has been nominal, and hence rates of return upon investment are not of great significance. If we assume that practically all expenses[7] of the holding company are directly assignable to the service arrangements, we can calculate the net income from services; expressing this figure as a percentage of the costs, we get a figure which the Federal Trade Commission has called the "percentage of profit on cost" of rendering the service. For the companies investigated by the Federal Trade Commission this figure not infrequently exceeded 100 per cent. Similarly, if one uses the rates of return earned on invested capital by servicing companies, the profitable character of the contracts is clearly evident.[8] The rates charged for general supervision service were typically two to three per cent of the gross earnings of the serviced company. How large the service charge would be if rendered at cost is difficult to say, but certain recent data indicate perhaps one per cent or less as a reasonable figure.[9] If one could venture a generalization concerning the service arrangements which existed rather generally throughout the utility industry until quite recently, it would be that the services rendered were for the most part genuine, that the operating companies were well managed and efficiently operated,[10] but that the charges made for service were usually sufficient to give the servicing organization a large profit.

One supposed advantage of this subsidiary arrangement in the utility industry was that in periods of financial stringency the operating

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[6] See FIELD, PUBLIC UTILITY HOLDING CORPORATIONS (1932); Wright, *Management Fees of Utility Holding Companies* (1930) 6 J. LAND AND PUB. UTILITY ECON. 415 *et seq.*; Wright, *Appliance Merchandising of Public Utilities* (1931) 7 J. LAND AND PUB. UTILITY ECON. 386-393; Note (1935) 49 HARV. L. REV. 957-993; and an article by the present writer, *Certain Aspects of Utility Service Contracts* (1934) 7 U. OF CHICAGO J. BUS. 106-123.

[7] Excluding certain expenses such as taxes, interest amortization, discounts, and commissions obviously not assignable to the servicing arrangement.

[8] See RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 6, at 57-59.

[9] *Ibid.* at 4, 5, and 60.

[10] *E. g.*, the testimony of a Federal Trade Commission examiner concerning the Electric Bond and Share Co. in 23 & 24 UTILITY CORPORATIONS, *supra* note 5, at 19.

company could always secure funds from its parent on reasonable terms. The official investigations have revealed two dangers or abuses in this creditor-debtor relationship. In certain now notorious instances it has been demonstrated that the holding company was doing most of the borrowing, to the detriment of the operating company's credit.[11] Where the holding company did lend funds to its operating subsidiaries the rates charged were at times excessive,[12] while in others there was reasonable doubt if the loan was actually necessary.[13]

For most public utility holding companies the primary source of income is dividends from subsidiaries.[14] The declaration and payment of dividends by subsidiary companies is of course largely determined by the holding company management. It is not surprising, therefore, that evidence exists that certain holding companies in the past have forced their subsidiaries to pay larger dividends than their earnings would warrant. The difficulties here are usually of two kinds: first, peculiar methods of calculating the earnings of the operating companies and of the holding companies, and second, the charging of dividends to credits other than to current net income or earned surplus.

In calculating net income available for distribution as dividends it is difficult to determine the proper allowance for depreciation. While it is impossible to say what depreciation rates should be used for utility assets, there is little doubt that some operating companies have made insufficient allowances.[15] As a consequence the net income available for

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[11] The following references describe in detail cases of this sort. NATIONAL ASS'N OF RAILROAD AND UTILITIES COMM'RS, PROCEEDINGS 44TH ANNUAL CONVENTION (1932) 100; BIENNIAL REP. OF PUB. SERVICE COM. OF STATE OF VT. (1929-1931) 85; 71 UTILITY CORPORATIONS, *supra* note 5, at 64; 72-A *Ibid.* at 856.

[12] The Associated Gas and Electric Company, for instance, regularly charged its subsidiaries 8% compounded monthly. 45 UTILITY CORPORATIONS, *supra* note 5, at 1591. Most of the operating companies could undoubtedly have borrowed from other sources at a lower rate.

[13] See 1 NEW YORK COMM. ON REVISION OF PUB. SERVICE COMM'S. LAW (1930) 134.

[14] For a number of important companies examined by the Federal Trade Commission, dividends, both stock and cash, from subsidiaries were 65% of the total. 72-A UTILITY CORPORATIONS, *supra* note 5, at 416-417. This, however, is a rough approximation at best.

[15] Concerning the very inadequate charges in the Insull group of properties (amounting to more than $90,000,000) see 59 UTILITY CORPORATIONS, *supra* note 5, at 251-2; 72-A *Ibid.* at 296-98.

The power and light industry has rather uniformly followed the retirement reserve theory of depreciation accounting. According to this theory, the burden of heavy retirements in any fiscal year should not be borne wholly by the income of that year; the essential requirement is that the reserve account be large enough to take care of retirements; there need be no fixed yearly charge to operating expense. The proponents of the theory emphasize the adequacy of a small reserve account which can prevent any serious distortion of operating expenses from year to year resulting from irregular property retirements. This reserve account may be built

dividend disbursements has been overstated. Prior to 1920 inadequate depreciation charges might be attributed to ignorance, but the same explanation is scarcely tenable in more recent years.[16]

The earnings of the operating companies were occasionally exaggerated by other means. Certain operating companies increased their net earnings by capitalizing all or a portion of the management supervision fee paid to the holding company.[17] Several holding companies derived net income for themselves by filing consolidated income tax returns for the whole group of companies while assessing the individual operating companies a sum equal to the tax they would have paid if they had filed individual returns.[18]

Such peculiar accounting procedures were of course invoked primarily to permit the operating companies to pay larger dividends on their common stocks. Insofar as these dividends represented distribution in excess of true net earnings, (*i.e.*, net earnings as calculated according to standard accounting procedure), they tended to weaken the financial condition of the operating companies involved. A financially weak com-

up by charges to operating expense or to surplus. For a further discussion see 72-A UTILITY CORPORATIONS, *supra* note 5, at 496-512.

For 91 operating companies, most of them large, which were examined by the Federal Trade Commission the ratio of retirement reserve expense to gross income for a one-year period was 6.87%. *Ibid.*, at 420. But there was considerable dispersion, *e.g.*, the Mississippi Power and Light Co. for 1930 allowed only 2.94% of gross income (42 *Ibid.* at 821), while the Duke Power Co. allowed 21.98% of gross income (76 *Ibid.* at 281). Similar calculations which express annual retirement depreciation charges as a percentage of fixed capital also show wide variations. Such calculations can be made from the Federal Trade Commission's reports, but space does not permit their presentation here. Study of the reports, however, clearly indicates that there are great differences in the depreciation policies of operating companies, that in some cases the charges have been clearly inadequate, and that as a consequence the net income of some operating companies has been dangerously overstated.

[16] See in this connection the Duke Power Company's defense of its depreciation charges higher than those allowed hy the Bureau of Internal Revenue for income tax purposes. 76 UTILITY CORPORATIONS, *supra* note 5, at 280-1.

[17] The general supervision fees are presumably an operating expense for the company receiving the service. But, between Nov. 1, 1923, and Dec. 31, 1928, the Minnesota Power & Light Co. capitalized supervision fees amounting to $249,504. 26 UTILITY CORPORATIONS, *supra* note 5, at 479. Other examples of the same practice have been uncovered in the records of the Pacific Power & Light Co. and the Northwestern Electric Company. 35 *Ibid.* at 147, 156. The absurd extremes to which the policy of capitalization of expenses may be carried is well illustrated by the case of the West Florida Power Co. in 1930. Exclusive of depreciation and federal income tax, this corporation had expenses of $35,787, but it capitalized expenses of $39,540, or in other words, expenses capitalized exceeded expenses incurred. The company actually showed a net credit on expense account. 72-A *Ibid.* at 486-7.

[18] In this fashion the Associated Gas and Electric Co. developed income for itself of $2,938,513 in the years 1926-1929. 45 UTILITY CORPORATIONS, *supra* note 5, at 1426-27. Other companies which followed similar practices were Cities Service Co., New England Power Association, New England Gas and Electric Association, and North America Co. 72-A *Ibid.* at 478-9.

pany necessarily finds it difficult and costly to raise additional capital for extensions and improvements that will reduce rates or improve service. If the operating company should actually become bankrupt or go into receivership because of unjustifiable dividends, consumers may be directly affected.

Finally, some holding companies have tended to "write-up" the value of fixed assets of operating companies and to recapitalize them on the basis of such larger valuations at a considerable profit to themselves. Insofar as the state commissions have allowed rates high enough to pay interest and dividends on these larger capitalizations the interests of consumers have been adversely affected.[19] More generally perhaps, consumers have been harmed whenever holding company control of operating companies has tended to destroy the effectiveness of state regulation.

II

HOLDING COMPANIES AND INVESTORS

The injury to investors in public utility holding company securities has in large measure resulted from the extreme extension of the holding company principle. As a financial device, it effectively concentrates control and enlarges the return upon the share capital of the control group. When kept within reasonable bounds, these are presumably legitimate pursuits; but when unduly extended they entail too great a risk for those who supply the bulk of the capital for a fixed return. The consequences and significance for investors of the application of the holding company principle in the utility industry may be conveniently discussed under three headings: (1) pyramiding and trading on the equity; (2) concentration of control; (3) complexity of capitalization and corporate structure.

1. *Pyramiding and Trading on the Equity.*[20] The financial risks of a corporation are a function of its capitalization. In the case of the holding company, however, we have more than one corporate entity; we have on the one hand the subsidiaries and their capitalization, and on the other the holding company (including any sub-holding companies) and its capitalization. Thus, we may express the ratio of debt to capitalization in two ways: (1) the ratio of the total debt of all companies

[19] The present writer has discussed this problem at some length in *The Capital Account and the Rate of Return in Public Utility Operating Companies* (1935) 43 J. POL. ECON. 50-68. See also BONBRIGHT AND MEANS, THE HOLDING COMPANY (1933) 163-67.

[20] It should be observed that trading on the equity in and of itself decreases the capital necessary to control any given aggregate of assets; while the use of the holding company principle in conjunction with it, renders concentration of control doubly easy. Similarly, a holding company increases the financial gains possible from trading on the equity.

in the system to the total capitalization or, (2) the ratio of the total subsidiary capitalization to the total debt of the top company.[21] In this connection the following table is interesting by way of illustrating the factual elements in the situation in 1932.

COMPOSITE CAPITALIZATION—19 UTILITY GROUPS[22]

Subsidiary Companies:	Capitalization	Percentage
Funded Debt	$3,536,475,848	37.94
Preferred stocks	1,490,520,717	16.00
Minority interest in common stock and surplus	155,556,772	1.67
Miscellaneous items	54,518,075	.59
Head Companies:		
Funded Debt	814,510,764	8.74
Preferred stock	958,453,188	10.29
Common stock and surplus	2,007,895,283	21.55
Miscellaneous items	299,763,292	3.22
	$9,317,663,939	100.00

For particular companies, of course, the percentage of debt to capitalization is very high. The highest was Genesee Valley Gas Company at 92.99 per cent, although some important groups well exceed 60 per cent.[23]

It must be observed that the common stock of the operating companies takes precedence over any bonds or debentures of the head company. In other words, bonds of holding companies, in the typical instance, are nothing more than prior claims against the dividends on the common stock of the operating companies.[24] The consequence is that the sum of the prior subsidiary items in the group capitalization has an important bearing on the stability of the holding company. In this respect there are wide variations between companies as indicated by the following figures showing the percentage of the prior subsidiary items in

[21] The present section leans heavily on the analysis developed by Commissioner Walter M. W. Splawn in RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 2, at 76-81.

[22] *Ibid.* at 73.

[23] *Ibid.* at 76. Some of the important groups in which consolidated indebtedness exceeded 60% were the following:

Associated Gas & Electric System	69.17%	1932
North American Light & Power Co	66.62%	1932
Federal Water Service Corporation	63.40%	1931
Central Public Service Corp	70.60%	1931
American Electric Power Corp	62.00%	1931

Certain cautions, however, are necessary in comparing the percentages for particular groups. See *Ibid.* at 78.

[24] This is not strictly accurate insofar as the holding company has sources of income other than securities.

the capitalization to total capitalization for several holding company groups.[25]

PERCENTAGE OF PRIOR SUBSIDIARY CAPITALIZATION TO TOTAL CAPITALIZATION

Company Group	Percentage	Year
American Water Works and Electric Co., Inc.	66.77	(1932)[26]
Associated Gas and Electric Co	39.81	(June 30, 1933)[27]
Central Public Service Corporation	59.0	(1931)[28]
Commonwealth & Southern Corporation	63.31	(1932)[29]
Duke Power Company	13.20	(June 30, 1933)[30]
Electric Bond & Share Companies		
American Gas & Electric Co	48.45	(1932)[31]
American Power & Light Co	59.28	(1932)[32]
Electric Power & Light Corp	67.50	(1932)[33]
National Power & Light Co	66.42	(1932)[34]
Federal Water Service Corp	70.11	(June 30, 1933)[35]
Niagara Hudson Power Corp	69.02	(June 30, 1933)[36]
The North American Co	67.04	(June 30, 1933)[37]
North American Light & Power Co	78.34	(June 30, 1933)[38]
Pacific Gas & Electric Co	48.99	(June 30, 1933)[39]
Public Service Corp. of New Jersey	41.32	(June 30, 1933)[40]
Standard Gas & Electric	68.74	(June 30, 1933)[41]
United Gas Improvement Co	49.44	(1933)[42]
Utilities Power & Light Corp	70.20	(June 30, 1933)[43]

The significance of a high percentage of prior subsidiary capitalization is that relatively small fluctuations in the income of the subsidiary produce quite violent fluctuations in the income applicable to the stock of the holding company. To cite a specific instance: in 1932, the gross operating revenues of the American Power & Light Company group were 10.67 per cent less than in 1931. But the amount of income applicable to the common stock of the American Power & Light Company, itself, declined 95.71 per cent.[44] In other words, only a slightly larger decline in gross operating revenues of the group would have left no income whatsoever applicable to the common stock of the American Power

[25] These percentage figures include only that common stock of the subsidiaries which is not owned by the holding company. The figures have been taken from RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 3. The precise figures for many companies are there given. Only a few are reproduced here. See also 72-A UTILITY CORPORATIONS, *supra* note 5, at 319.

[26] RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 3, at 57.

[27] *Ibid.* at 105.
[28] *Ibid.* at 135.
[29] *Ibid.* at 230.
[30] *Ibid.* at 430.
[31] *Ibid.* at 490.
[32] *Ibid.* at 506.
[33] *Ibid.* at 525.
[34] *Ibid.* at 546.
[35] *Ibid.* at 561.
[36] *Ibid.* at 691.
[37] *Ibid.* at 715.
[38] *Ibid.* at 744.
[39] *Ibid.* at 773.
[40] *Ibid.* at 792.
[41] *Ibid.* at 848.
[42] *Ibid.* at 910.
[43] *Ibid.* at 943.
[44] *Ibid.* at 507.

& Light Company. Similarly, for the Cities Service Co. group in 1931 when total gross earnings declined 16.90 per cent below the previous year, the earnings available for the common stock were wiped out entirely.[45] Another method of presenting the same information in perhaps a more convenient form is to express the net income available to the common stock of the holding company as a percentage of the net income of the group (*i.e.*, a total income minus expenses).[46] As an illustration, in 1931 the consolidated net income of the American Power & Light Company group was $41,409,125 and the amount available for the common stock of the American Power & Light Company was $6,142,546, which is a percentage ratio of 14.8 per cent. Similarly for 1932 the percentage ratio was 0.74 per cent. In the following table percentages such as those just explained are given for a number of the principal holding company groups.[47]

PERCENTAGE RATIO OF RESIDUE AVAILABLE FOR COMMON STOCK OF HOLDING COMPANY TO GROUP NET INCOME

Company Group	1930	1931	1932	1933 (June 30)
American Commonwealth Power Corp.	73.8	2.2	.....	.....
American Water Works & Electric Co., Inc.	29.7	28.1	19.1	14.7
Associated Gas & Electric Properties	48.2	30.4	13.2	.....
Central Public Service Co.	21.0	5.8	.....	.....
Commonwealth & Southern Corp.	32.5	22.2	8.0	.....
Duke Power Co.	65.9	62.0	51.1	55.5
Electric Bond & Share Companies				
American Gas & Electric Co.	51.1	47.9	.....	.....
American Power & Light Co.	21.6	14.8	0.7	.....
Electric Power & Light Corp.	16.6	10.9	.....	.....
National Power & Light Co.	34.1	29.3	23.8	.....
Federal Water Service Corp.	15.8	3.8	.....	.....
Niagara-Hudson Power Corp.	.....	35.8	27.5	17.8
The North American Co.	47.3	45.2	.....	.....
North American Light & Power Co.	23.2	16.4	.....	.....
Public Service Corp. of New Jersey	48.3	45.7	42.6	.....
Standard Gas & Electric	20.1	13.8	.....	.....
United Gas Improvement Co.	59.2	59.5	57.6	.....
Utilities Power & Light Corp.	56.7	31.1	Deficit	.....
The United Light & Power Co.	20.0	13.7	2.2	.....

[45] *Ibid.* at 197.

[46] Excluding interest charges from expenses, of course. Dr. Splawn calls this the "stability ratio."

[47] Data taken from RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 2, at 79-80. Some caution is necessary in interpreting these figures. In any comparison of one year with another, it must be borne in mind that any increase or decrease in indebtedness will affect the ratio. Likewise, changes in depreciation charges, increases or decreases in the number of subsidiaries, and perhaps other factors as well, serve to alter the ratio.

From the standpoint of investors, the danger of a highly pyramided structure, therefore, is that a decline in the net income from operations may render the securities of the top companies quite valueless. In the final analysis, no matter how many companies are interposed between the holding company and the operating companies, the ultimate source of all income is the operating company, the only company which has any direct contact with the consumers of utility services. When we observe a highly pyramided structure, therefore, we are inclined to remember the Middle West Utilities, concerning which a Federal Trade Commission examiner wrote:

> "For Middle West Utilities Co. to benefit from any dividend declared by Florida Power Corporation on its common stock it will be seen that it is necessary for such dividend to 'trickle up' through the various holding companies, and by the time each of these companies has taken out a portion to cover its individual needs for expenses, taxes, interest, and preferred dividends a very small portion is left; in fact, it has disappeared long before it reaches the top."[48]

2. *Concentration of Control.* The problem of measuring objectively the degree to which concentration of control exists in any holding company is somewhat difficult. As a first approximation, the simplest measure is the ratio of the book value of the voting stock of the top company in the group to the total outstanding securities of the group.[49] The table on page 527 gives this ratio for a number of important holding companies as of December 31, 1931. It illustrates the degree to which concentration of control had been carried in the more important holding companies by that date.

3. *Complexity of Capitalization and Corporate Structure.* While the movement towards greater complexity and variety in security issues has been general in the last few years, it is perhaps true that the public utility holding companies have for some time set the pace. Complexity in capitalization was possibly carried to its ultimate extremity in the Associated Gas and Electric Company. As of December 31, 1931, this company had outstanding 12 different bond issues, 10 issues of preferred stock, a Class A stock, a Class B stock, and an issue of common stock.[50] The enormous number of issues is alone enough to make any calculation

[48] 59 UTILITY CORPORATIONS, *supra* note 5, at 256.

[49] While highly informative there are cases where the ratio is somewhat misleading. The Cities Service Co., for example, at Mar. 14, 1931, had outstanding 34,172,158 shares of voting stock divided among five issues, and having a total of 3,803,005 votes between them. But a special $1,000,000 issue of preferred stock, par value $1 per share and entitled to one vote per share, was entirely owned by Henry L. Doherty and Company which thereby secured to itself more than 25% of the voting control of the Cities Service Co., with an investment of $1,000,000. See 66 UTILITY CORPORATIONS, *supra* note 5, at 789. Between 1924 and 1929, H. M. Byllesby and Co. owned a similar stock issue of the Standard Gas and Electric Co. 36 *Ibid.* at 290-1.

[50] RELATIONS OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 2, at 56-57.

RATIO OF BOOK VALUE OF VOTING STOCK OF HEAD COMPANIES TO TOTAL CAPITAL LIABILITIES OF GROUPS, 1931

Name of Company	Book Value of Voting Stock of Head Company in Thousands of Dollars	Total Capital Liabilities in Thousands of Dollars	Percent	
Am. Commonwealth P. Corp.	4,590	186,233	2.46	
Am. Pwr. & Light Co.	214,645	694,389	30.91	(1933)
Am. Water Wks. & El. Co.	17,508	352,584	4.97	
Am. Gas & El. Co.	74,366	441,095	16.86	
Ass. Gas & El. Properties	2,962	807,526	3.29	
Central Public Service Co.	4,078	317,923	1.28	
Cities Service Co. (1)	418,830	1,087,317	38.52	
Commonwealth & Southern Corp.	168,366	1,046,249	16.09	
Consolidated Gas Electric Light & Power Co. of Baltimore	13,211	141,242	9.35	
Detroit Edison	127,226	276,629	45.99	
Duke Power Co.	112,198	177,172	63.33	
Edison El. Ill. Co. of Boston	53,487	161,690	33.08	
Electric Bond & Share Co.	292,333	540,335	54.10	
Elec. Pwr. & Light Corp.	154,943	808,481	19.16	
Federal Water Service Co.	2,500	165,673	1.18	
Hartford Electric Light Co.	21,000	30,915	67.93	
Internat. Hydro-El. System	2,000	508,320	0.39	
Lone Star Gas Corp.	65,250	124,729	52.31	
National Power & Light Co.	97,730	552,835	17.68	
New Eng. Gas & El. Assoc.	20,000	44,206	45.24	(1932)
New Eng. Water Light & Power Associates	3	2,332	0.13	
Niagara-Hudson Power Corp. (2)	261,490	725,500	36.04	
North American Co.	68,254	718,431	9.50	
North American Lt. & Pwr. Co.	40,356	316,672	12.74	
Ohio Oil Co.	100,000	175,326	57.04	
Pacific Gas & El. Co.	270,412	630,085	42.92	
Pacific Lighting Corp.	44,772	194,215	23.05	
Public Service Corp. of N. J.	308,622	631,526	48.87	
Standard Gas & Electric Co.	173,476	1,077,224	16.10	
Stone & Webster, Inc.	50,000	353,008	14.16	
United Gas Improv. Co.	200,000	639,627	31.27	
United Light & Power Co.	4,271	439,032	0.97	
Western Mass. Companies (1)	25,016	34,185	73.18	
Western Public Service Corp. (1)	33,586	35,586	94.38	

(1) includes surplus.

(2) consolidated basis including surplus.

of their individual investment values extremely difficult, if not impossible.[51] The complexity of the whole structure was further increased by the numerous convertible provisions attached to certain issues. Some were convertible at the holder's option; others at the company's option. The payment of dividends was likewise complicated; dividends on certain of the preferred shares could be paid (at the holder's option) in Class A stock; while dividends on the latter were payable, under a confusing arrangement, either in cash, or in fractional amounts of the Class A stock itself.[52] Theoretically, it should be possible to determine the relative position and merits of any particular security in a corporate structure without undue difficulty;[53] but where in this company and others,[54] non-voting shares, stock-purchase warrants, convertible securities, *etc.*, are combined in the capitalization it becomes enormously difficult.

Complexity of capitalization tends in practice to be associated in public utility holding companies with complexity of corporate structure, although the two are theoretically distinct. In many cases the extreme complexity of the corporate interrelations was not emphasized or even made known to investors. For example, from the information generally available one would have inferred that the Associated Gas and Electric Co. was a holding company having direct control of a number of operating companies; in reality (as of March 31, 1932) the Associated Gas & Electric Co. controlled nothing but the Associated Gas & Electric Corporation (Delaware), which in turn controlled no operating companies but only sub-holding companies such as Associated Electric Company (Delaware), Rochester Central Power Corporation (Delaware) and others. These latter companies then controlled sub-sub-holding companies which in turn usually controlled operating companies doing business with the public.[55] Further complexities arose because of a considerable inter-ownership of securities among the companies in the system.[56]

Standard Gas & Electric Co. with consolidated assets exceeding a

[51] On at least two occasions the various types and kinds of securities in the structure seem to have gotten a little beyond the controlling interests themselves, for in April, 1929, and again in June, 1931, the board of directors found it necessary to pass retroactive resolutions ratifying certain security issues which had already been made. 45 UTILITY CORPORATIONS, *supra* note 5, at 1254-55.

[52] 45 UTILITY CORPORATIONS, *supra* note 5, at 1269.

[53] The company reported, "We have to advise that there is no segregation as to the value of the individual issues [of stock] reflected on the books of the company." See RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 3, at 109.

[54] *E.g.*, the capital structure of Cities Service Co., Federal Water Service Corp., Electric Power & Light Corp., American States Public Service Co., American Commonwealth Power Corp., and others as they existed in 1931 for further illustrations.

[55] See RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 3, at 63.

[56] See 50 UTILITY CORPORATIONS, *supra* note 5, at 995, 1026.

billion dollars was controlled by the Standard Power & Light Corp. which was controlled jointly by H. M. Byllesby & Co. and the United States Electric Power Corp.. H. M. Byllesby & Co. was controlled by the Byllesby Corporation, while the United States Electric Power Corporation was controlled jointly by United Founders Corporation and American Founders Corporation, the latter being controlled by the former.[57] Other notable cases of complexity of intercorporate relations were Central Public Service Co. and the Insull group. Until 1932, the Insull utility "empire" consisted of five principal systems; three were headed by operating companies[58] and two by holding companies, Middle West Utilities Co. and Midland United Company. The Middle West Utilities Company at the date of receivership (April 15, 1932) owned or controlled a system of 239 operating companies, 24 holding companies and 13 non-operating subsidiaries. The corporate structure of Midland United Company was not complex, most of the operating subsidiaries being controlled directly or once removed. Moving upwards from the five systems, however, the structure became exceedingly complex. The five systems above named were controlled by two investment companies: *viz.*, Insull Utility Investments, Inc. and Corporation Securities Company of Chicago; but Insull Utility Investments, Inc. had three subsidiaries—Insull, Son & Co., Inc., Public Service Trust, and Second Utilities Syndicate, Inc.; while Corporation Securities Company of Chicago, the other investment company, owned 100 per cent control of Corporation Syndicates, Inc. and a 25 per cent control in both Second Utilities Syndicate, Inc., and Public Service Trust. Unfortunately the ramifications did not stop here, for we find that Corporation Securities Company of Chicago owned 26 per cent control of Insull Utility Investments, Inc., while the latter, in turn, owned 18 per cent voting control of the former (Corporation Securities Company of Chicago). Finally, the control of Corporation Securities Company of Chicago and Insull Utility Investments, Inc. rested with the Insull family and the banking firm of Halsey, Stuart and Compauy.[59] Where almost all the companies named had securities outstanding in the hands of the public in large amounts, it is difficult to condone the hopeless complexity of the foregoing. One is merely reminded of the pronouncement of the Investment Bankers Association concerning holding company securities in 1925: "This is a perfectly legitimate investment for the investor who knows what he is getting."[60]

[57] See RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 3, at 851-2.

[58] Commonwealth Edison Co., People's Gas Light and Coke Co., and Public Service Co. of Northern Illinois.

[59] See 60 UTILITY CORPORATIONS, *supra* note 5, at 507; RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 5, viii, xiv, and 479 *et seq.*

[60] RIPLEY, MAIN STREET AND WALL STREET (1927) 316.

The dangers of highly complicated corporate structures have been frequently discussed; from the standpoint of investors the primary difficulty is to appraise the investment merits of the numerous security issues. Where there is considerable inter-ownership of securities it is increasingly difficult to estimate the probable income stream accruing to a particular issue. Furthermore, the determination of the income of a particular company among many closely interrelated companies is partially a matter of discretion and arbitrary decision.[61] When the corporate structure becomes so involved that even professional financiers find difficulty in tracing it through, one wonders if the purposes can be assumed to be in the public interest.[62] If, for example, there had been full disclosure and a simpler corporate structure, would it have been possible for some of the Insull companies to have pledged almost all their assets for loans, and to have used the proceeds to speculate on the exchange in the companies' securities? Perhaps one of the men connected with the formation of the Corporation Securities Company of Chicago was approximately correct when he wrote to an associate, "In my opinion, the minute we disclose the assets of the company, it will in great measure defeat the purpose of the whole thing."[63]

Weaknesses of public utility holding company securities have largely arisen from the unique character of holding companies. It is common knowledge, however, that during the boom the corporate device was utilized in a manner contrary to the interests of investors in many industries. As a consequence owners of utility holding company securities suffered additional injury from these developments. In this category are to be included: certain dangerous practices associated with no-par stock, lack of adequate publicity of corporate affairs, misleading financial statements, peculiar accounting practices with respect to the computation of earnings, the creation of artificial market prices for securities, exploitation of corporations by directors and officers, and perhaps others.[64]

[61] See 45 UTILITY CORPORATIONS, *supra* note 5, at 1365 for an interesting example.

[62] In a brief filed by the Attorney General of New Hampshire it was written: "Where there is smoke there must be some fire; and in the case at bar it is respectfully and not venomously submitted to this court that when a regulatory body finds the local corporations, to which its inquiries are limited, entirely surrounded by and engulfed in a smoke screen of foreign corporations, absentee directors, and unknown control, it may properly reach a conclusion that the affairs of the local corporation are not being handled properly or independently." RUGGLES, PROBLEMS IN PUBLIC UTILITY ECONOMICS AND MANAGEMENT (1933) 639.

[63] RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, *supra* note 5, Part 5, at 639.

[64] For an interesting example of corporate exploitation see the General Gas and Electric case described in 70 UTILITY CORPORATIONS, *supra* note 5, at 796-864; concerning market manipulations, *etc.* see 72-A *Ibid.* at 535-98; on peculiar accounting methods in calculating earnings see 72-A *Ibid.* at 468-73, 512-27. An interesting essay on the dangers and abuses of no-par value shares will be found in 73-A *Ibid.* at 83-108.

These abuses, while reprehensible, were not, in the writer's opinion, especially peculiar to utility holding companies. As a consequence they call for no special treatment here, even though they do partially explain the very large losses suffered by the holders of utility holding company securities.

III

HOLDING COMPANIES AND THE GENERAL WELFARE

Quite apart from the direct injury to consumers and investors it may be argued that the activities of public utility holding companies have in the past been hostile to the maximization of national well-being. One might contend, for example, that in a variety of ways, holding companies have tended to neutralize the efforts of sovereign bodies to regulate an industry peculiarly "affected with a public interest." Again, one might insist that in not a few cases unregulated holding company development has resulted in combinations of properties and companies not well suited to attaining the highest technical efficiency.[65] The concentration of control of large aggregates of capital, sometimes exceeding a billion dollars, in a very few hands would undoubtedly be regarded by many students as inherently dangerous.[66] Some would feel that a sovereign authority cannot afford to permit the rise of any organization which would endanger or threaten the exercise of its sovereign power. While it could be argued that some improvement in the operation of the capital markets was essential to insure the allocation of new capital to its more productive uses, it could hardly be maintained that the abuses in the flotation and sale of public utility securities were comparatively of outstanding severity. On the whole, one might insist, with some reason, that the public utility holding company system as it existed until recently was not in harmony with the greatest general good.

IV

STATE REGULATION

In considering the merits and defects of state commission regulation of public utility holding companies, one must consistently remember the

[65] Different holding companies have developed under quite different theories concerning the acquisition of subsidiaries. Companies like the Electric Bond and Share Co., the Associated Gas and Electric Co., Central Public Service Co., and others apparently operated on the principle of acquiring subsidiaries in different parts of the country, hoping thereby to spread their economic risk. Companies like Public Service Corp. of New Jersey, New England Power Association, Niagara-Hudson Power Corp., and others, however, apparently sought to build up an integrated and interconnected group of subsidiaries in one geographical area. As we shall observe later, recent legislation manifests a distinct preference for the second type of holding company.

[66] Presumably because of the tremendous influence the control group is capable of exerting in economic, political, and social affairs. It is perhaps easy to overemphasize the significance and importance of these "interests"; in no small measure by having different interests they tend to checkmate one another. But the dangers to public welfare may at times be very real.

avowed purpose of state regulation of public utilities. State commissions are concerned with the problems of consumers of utility service; their function is to assure consumers adequate service at reasonable rates. So far as the laws of their states permit the commissions exercise jurisdiction over public utility operating companies; their interest in and control over holding companies is but a means to a more effective control over operating companies. Problems of investors, questions relating to national policy, *etc.*, have not been their concern; and the evils and abuses of public utility holding companies along these lines cannot be charged to the "ineffectiveness" of state regulation. At various points, however, the operations of holding companies impinge upon the sellers of utility service, and here state authorities have sought to regulate. To a consideration of such regulation we must now turn.

1. In recent years state commissions have devoted increased attention to service contracts and arrangements between operating utility companies and affiliated interests. So far as can be determined the public service commissions in twenty states[67] have power under specific laws to regulate service contracts between utility companies and "affiliated interests."[68] Whether commissions which have not been specifically granted jurisdiction over service contracts would be upheld by the courts if they attempted to do so is not easily answered.[69]

The difficulties which the state commissions have encountered in attempting to regulate service contracts are mainly two: (1) the expense necessary to investigate and determine the reasonableness of the charges levied by the holding companies for services; and (2) the legal barriers which until quite recently prevented the commissions from passing upon the reasonableness of the charges imposed. It is notorious, of course, that the budgets of most commissions in the past have been insufficient to carry out to the full the obligations imposed upon them.[70]

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[67] These states were: Alabama, Connecticut, Illinois, Indiana, Kansas, Louisiana, Maine, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Oregon, Pennsylvania, South Carolina, Vermont, Virginia, Washington, West Virginia, Wisconsin.

[68] New York has passed a law requiring competitive bidding on all plant construction costing more than $25,000. 1 N. Y. Laws 1935, p. 21.

[69] It might be argued that the commission was exceeding the powers delegated to it by the legislature. It is worth noting, however, that the Alabama Commission, without an enabling statute, issued a general order suspending all further payments to affiliated interests until the companies demonstrated the reasonableness of the charges. P. U. R. 1932E, 347. This order was subsequently modified however.

[70] It has been pointed out that in 1929–30 the average appropriation for the state commissions was less than $150,000; earlier it was less. MOSHER AND CRAWFORD, PUBLIC UTILITY REGULATION (1933) 70. Recent legislation, however, attempts to impose upon the utilities a greater portion of the costs of regulation. Hormell, *State Legislation on Public Utilities in 1933* (1934) 28 AM. POL. SCI. REV. 84; Mar-

The regulation of service contracts is only one aspect of this general problem. On the legal side, commissions might attack servicing fees on either or both of two grounds: (i) that the fees were unreasonable, and (ii) that a contract between a holding company and a controlled subsidiary is not a valid contract because it is not a contract between two parties dealing at arm's length.

(i) The test of reasonableness of servicing, management or other fees has been under consideration by the courts in several important cases. In *Houston v. Southwestern Bell Telephone Co.*[71] it was held that if the cost to the operating company was no greater than the price the company would pay for similar service from some non-affiliated company, then the charge was presumably fair. Eight years later (1930), however, the Supreme Court held that cost to the company rendering the service was relevant. In *Smith v. Illinois Bell Telephone Co.*[72] Chief Justice Hughes wrote:

> ". . . we see no reason to doubt that the valuable services were rendered by the American Company, but there should be specific findings by the statutory court with regard to the cost of these services to the American Company. . . ."

In other words, it would seem that the cost of rendering the service is an element to be considered in determining the reasonableness of service charges. But how much weight should be given to cost is apparently undetermined.

(ii) The validity of contracts between a controlled and a controlling company has been generally upheld. It is apparently established that contracts cannot be set aside on this ground alone. As Lilienthal has stated after an exhaustive examination of the relevant cases:

> "The right of the commission critically to examine these disbursements, and to disallow or reduce them is confirmed. But such disallowance or reduction made simply because one of the contracting parties is controlled by the other is error: the fact of control is 'not important' beyond justifying the commission in subjecting the contract to close scrutiny to prevent imposition on the rate-payers. If the operating company could have secured better terms by dealing with an outsider, or if there is 'bad faith' or 'abuse of discretion' disclosed, then the commission may, and should refuse to approve the terms of the contract with the controlling company."[73]

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lett and Traylor, *Public Utility Legislation in the Depression* (1935) 11. J. LAND AND PUB. UTILITY ECON. 294–301; Marlett and Marple, *Public Utility Legislation in the Depression, Ibid.* at 392–394.

[71] (1922) 259 U. S. 318.

[72] (1930) 282 U. S. 133, 157.

[73] Lilienthal, *The Regulation of Utility Holding Companies* (1929) 29 COL. L. REV. 404, 416. The position of the courts in this regard is well expressed in State Public Utilities Com. v. Springfield Gas & Elec. Co. (1920) 291 Ill. 209, 234, 125 N. E. 891, 901, where the court said: "the commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers." See Missouri v. Public Service Com. (1923) 262 U. S. 276.

Until quite recently the presumption was that contracts between parent and subsidiary were in good faith and that the burden of proof to the contrary rested with the regulatory authorities.[74] But in 1932, in a unanimous decision, the Supreme Court took a somewhat different attitude although the question of service contracts was not directly under consideration. In *Western Distributing Co. v. Public Service Commission of Kansas*[75] Justice Roberts wrote:

> "Having in mind the affiliation of buyer and seller and the unity of control thus engendered, we think that . . . if appellant desired an increase of rates it was bound to offer satisfactory evidence with respect to all the costs which entered into the ascertainment of a reasonable rate. Those in control of the situation have combined the interstate carriage of the commodity with its local distribution in what is in practical effect one organization. There is an absence of arm's length bargaining between the two corporate entities involved, and of all the elements which ordinarily go to fix market value. The opportunity exists for one member of the combination to charge the other an unreasonable rate and thus to make such unfair charge in part the basis of the retail rate. The state authority whose powers are invoked to fix a reasonable rate is certainly entitled to be informed whether advantage has been taken of the situation to put an unreasonable burden upon the distributing company, . . ."

Such language does not seem to place the full burden of proof of lack of good faith upon the commissions. Although the company showed that no gas could be obtained elsewhere at a lower rate, and that other cities and towns in the region paid the same rate, even from an independent pipe line company, the court held this did not establish the reasonableness of the rate in question.[76]

So far as can be determined only one case has come up to the Supreme Court bearing upon the question of the power of a state public service commission to have access to the accounts and records of affiliated interests. In 1932 the Kansas Corporation Commission ordered the Wichita Gas Company (a Cities Service Company subsidiary) to cease recording a contract management fee of one and three-fourths per cent of its gross earnings as an expense.[77] The company sought to enjoin the enforce-

[74] "The presumption is that this contract was entered into in good faith and in the exercise of a proper discretion by the officers of both corporations. To overcome this presumption, it was incumbent on the defendants [state authorities] to show that the contract was not made in the exercise of a proper discretion by the plaintiff's officers." Northwestern Bell Tel. Co. v. Spillman (D. Neb. 1925) 6 F. (2d) 663, 664. Quoted also by Lilienthal, *op. cit. supra* note 59, at 419-420.

[75] (1932) 285 U. S. 119, 124. This case involved a pipe line company selling gas to a retail company where both were controlled by the same holding company (Cities Service Co.). The question at issue was whether the commission had any right to question the propriety of the price at which the retail company purchased gas at wholesale from the pipe line company.

[76] *Ibid.* at 125. See Dayton Power & Light Co. v. Public Utilities Com. (1934) 292 U. S. 290, 307-308.

[77] The order also required the Wichita Gas Company not to charge as expense more than thirty cents per 1,000 cubic feet for gas purchased from the Cities Service Gas Company.

ment of the order. The District Court of the United States for the District of Kansas granted this request, whereupon the state commission took an appeal to the Supreme Court. In passing on the question the court said:

> "But the commission's proceedings are to be regarded as having been taken to secure information later to be used for the ascertainment of reasonableness of rates. The order is therefore legislative in character. The commission's decisions upon the matters covered by it cannot be *res ajudicata* when challenged in a confiscation case or other suit involving their validity or the validity of any rate depending on them." [78]

In summary then we may venture the following. Contracts between affiliated interests are not invalid *per se*.[79] But contracts between affiliated interests require a special scrutiny to assure that no special advantage has been taken in the absence of arm's length dealing.[80] While earlier the market value of the service was regarded as the test of a reasonable contract,[81] more recently cost to the party rendering the service has been ruled relevant, although the weight to be assigned to cost is probably undetermined.[82] The burden of proof as to the fairness of contracts between affiliated interests has been largely shifted from the commissions to the companies.[83] A state commission has power to demand a showing of cost to affiliates of rendering services as a preliminary to determining the fairness of certain expense items which will be relevant in determining the fairness of charges to the public.[84]

2. The dangers inherent in "up-stream" loans have caused certain states to prohibit these transactions by recently enacted statutes. In Illinois, Maryland, Kentucky, and Washington, public utilities may not "lend their funds, pledge their credit, or assume liabilities, directly or indirectly, in behalf of any other person or company without commission approval."[85] Other states supply similar restrictions to loans and credit extensions to "affiliated interests"[86] or stockholders.[87]

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[78] State Corporation Com. v. Wichita Gas Co. (1934) 290 U. S. 561, 569.

[79] Missouri v. Public Service Com., *supra* note 73.

[80] Western Distributing Co. v. Public Service Com., *supra* note 75.

[81] Houston v. Southwestern Bell Tel. Co., *supra* note 71.

[82] Smith v. Illinois Bell Tel. Co., *supra* note 72; Western Distributing Co. v. Public Service Com., *supra* note 75; Dayton Power & Light Co. v. Public Utilities Com., *supra* note 76.

[83] Dayton Power & Light Co. v. Public Utilities Com., *supra* note 76.

[84] State Corporation Com. v. Wichita Gas Co., *supra* note 78.

[85] Marlett and Traylor, *Public Utility Legislation in the Depression* (1935) 11 J. LAND AND PUB. UTILITY ECON. 182.

[86] Kansas, Maine, Oregon, Pennsylvania, Virginia and Wisconsin. Marlett and Traylor, *loc. cit. supra* note 85.

[87] New York and North Carolina. Marlett and Traylor, *loc. cit. supra* note 85. In 1935 New Jersey required by law commission approval of all loans between affiliated utilities. N. J. Laws 1935, p. 124. See Hormell, *State Legislation on Public Utilities in 1934–35* (1936) 30 AM. POL. SCI. REV. 522, 535. In 1935, Massachusetts granted its commission power to review and investigate all financial trans-

3. According to the Bonbright Utility Regulation Chart, by 1930, twenty-one states had enacted laws giving their commission regulatory authority over depreciation. But in most states the law simply granted the commission power, in its discretion, to set up various and sundry rules pertaining thereto. In recent years, however, it has been recognized that this was not enough. The Illinois law now prohibits a utility from paying "any dividend upon its common and preferred stock unless it shall have set aside the depreciation annuity prescribed by the commission or a reasonable depreciation annuity if none has been prescribed." In Pennsylvania in 1933 the law was modified to make depreciation accounts obligatory rather than at the discretion of the commission. Recent legislation in Wisconsin requires the utilities to submit their proposed rates to the commission which may approve them or substitute others; furthermore, the commission may revise them from time to time in the light of new data. More interesting perhaps is the provision that no dividends shall be paid or no credits made to surplus until the proper depreciation credit has been recorded on the books.[88]

The important legal question with reference to the foregoing laws is the power of the state commission to require an adequate and sufficient allowance for depreciation. That the commissions have such power is beyond question; but so also is the power of the federal courts to review.[89] By what tests of "reasonableness," therefore, do the courts appraise the findings or regulations of the commissions? First, the burden of proof rests with those who disagree with the commission's findings, the state commissions being proper authorities.[90] On the question of retirement reserves versus depreciation reserves the Supreme Court is apparently open-minded and of the opinion that "actual experience . . . is more convincing than tabulations of estimates."[91] In the *Baltimore Railways* case the majority of the court held that depreciation charges must be based on present value and not upon cost.[92] But in the more recent

actions between operating gas and electric companies and "affiliated" companies. *Ibid.* at 534. See Marlett and Marple, *op. cit. supra* note 70, at 397.

[88] Marlett and Traylor, *op. cit. supra* note 85, at 185–186.

[89] Los Angeles Gas & Electric Corp. v. Railroad Commission (1932) 289 U. S. 287, 304, 305.

[90] "It is enough that the rates have been established by competent authority and that their invalidity has not been satisfactorily proved." Lindheimer v. Illinois Bell Tel. Co. (1933) 292 U. S. 151, 175. See Los Angeles Gas & Elec. Corp. v. Railroad Commission, *supra* note 89; Dayton Power & Light Co. v. Public Service Com., *supra* note 76.

[91] Lindheimer v. Illinois Bell Tel. Co., *supra* note 90, at 163. "Elaborate calculations which are at war with realities are of no avail." *Ibid.* at 164.

[92] United Railways & Elec. Co. of Baltimore v. West (1929) 280 U. S. 234. At page 253 the court said, "The allowance for annual depreciation made by the commission was based upon cost. The Court of Appeals held that this was erroneous and that it should have been based upon present value. The court's view of

Lindheimer case the practice of the company in using the "straight-line" method of depreciation was not attacked by the courts on the grounds that it was based on cost, but because the depreciation charges were in excess of the actual observed depreciation.[93] What if depreciation charges have been inadequate or excessive in the past, may they therefore be made larger or smaller in the future to serve as a corrective? In *Board of Public Utility Commissioners v. New York Telephone Co.*[94] the court, while admitting past allowances for depreciation had been excessive, said:

> "Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory. . . . And the law does not require the company to give up for the benefit of future subscribers any part of its accumulation from past operations. Profits of the past cannot be used to sustain confiscatory rates for the future."

In *Smith v. Illinois Bell Telephone Co.*[95] this doctrine was reiterated and the court further said that "past experience is an indication of the company's requirements for the future." In other words, an error when discovered need not be repeated, but the results of past errors stand.

In would appear, therefore, that commissions are bodies competent to pass upon depreciation charges, and in the absence of strong proof to the contrary the Supreme Court will uphold their judgment; the proper rule, however, is to calculate depreciation with reference to present value rather than cost; and, finally, in the opinion of the courts, no one method of handling depreciation is clearly superior to all others.

4. Apparently very few state commissions have been granted specific jurisdiction over the dividend payments of operating public utilities. The Bonbright Chart of 1929 does not even mention dividends, despite specific information on a number of points.[96] Marlett and Traylor in their survey of state laws mention the following regulations.[97] In Alabama and Washington utilities are prohibited from paying dividends unless their (1) "Earnings and surplus after proper reserves, are sufficient to enable the Company to do so, and (2) the payment will not impair the ability of the utility to perform its duty to render reasonable

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the matter was plainly right." Justices Brandeis and Holmes in a strong dissenting opinion severely criticized this view. *Ibid.* at 255.

[93] While the court in the Lindheimer case describes the "straight-line" method of depreciation, it nowhere passes judgment upon it. The writer of Note (1934) 48 HARV. L. REV. 83, 88, is of the opinion that the rule that depreciation must be based on "present value" (as expressed in the Baltimore Railways case) still holds.

[94] (1925) 271 U. S. 23, 31–32.

[95] *Supra* note 72, at 150.

[96] See 18 & 19 UTILITY CORPORATIONS, *supra* note 5, at 352–9. A more revised form of this chart (still not mentioning dividends) is to be found in House Committee on Interstate and Foreign Commerce, HEARINGS ON H. R. No. 5423 (1935) 74th Cong. 1st Sess., 1935–36.

[97] Marlett and Traylor, *op. cit. supra* note 85, at 184.

and adequate service at reasonable rates." The meaning of surplus for purposes of applying this provision is not indicated. In both states, moreover, the commission may order the cessation of dividends if it finds the utility's capital is impaired. In Illinois and Wisconsin[98] the provisions are similar but further include the previously mentioned requirements regarding depreciation. In Kansas the commission may prohibit dividends if it appears that financial condition or service are likely to be adversely affected.

Few cases have come before the courts involving these statutes restricting dividends. The Washington supreme court, however, has ruled that the requirements in that state apply only to companies doing a strictly intrastate business.[99] In Ohio the supreme court upheld the commission's power to prohibit the payment of dividends when there were neither earnings nor surplus, and when the continuation of such payments would result in deterioration of service and properties.[100]

5. In very recent years some few states have endeavored to check the undesirable extension of holding companies by either or both of the following: (1) imposing restrictions on the acquisition by one utility of the voting stock of another; and (2) requiring commission approval before holding companies may acquire the stock of an operating company. But in general such statutes merely require the commission to approve or disapprove and do not specify the principles on which a decision is to be reached.[101] Where such statutes have come before the courts the decisions have been generally unfavorable to the extension of the commission's powers.[102]

The whole question of state commission control of the capitalization of operating companies, the issuance of securities to holding companies, *etc.*, while bearing upon the question of state regulation of holding-oper-

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[98] In 1932 the Wisconsin Commission ordered certain operating companies to cease paying dividends on their common stock. P. U. R. 1933A, 253. But there has been no judicial review. See Legis. (1932) 45 HARV. L. REV. 729.

[99] State *ex rel.* Washington Water Power Co. v. Murray (1935) 181 Wash. 27, 42 P. (2d) 429, 10 P. U. R. (N. S.) 330.

[100] Ohio Central Tel. Corp. v. Public Utilities Com. (1934) 127 Ohio 556, 189 N. E. 650, 2 P. U. R. (N. S.) 465.

[101] A useful digest of state laws on this point will be found in 69-A UTILITY CORPORATIONS, *supra* note 5, at 198–221. A number of the important commission decisions are discussed in Hall, *State Control of Consolidation of Public Utilities* (1932) 81 U. OF PA. L. REV. 8, 16–21, 27.

[102] *E.g.*, Electrical Public Utilities Co. v. West (1928) 154 Md. 445, 140 Atl. 840, where it was held that the commission could only refuse to grant a holding company permission to acquire the stocks of certain operating companies if the commission could demonstrate that the acquisition was against the public interest. See New York State Elec. Corp. v. Public Service Com. (1929) 227 App. Div. 18, 236 N. Y. Supp. 411.

ating company relations has too many ramifications to be dealt with here in the space available.

6. It is apparent from the foregoing that indirect state regulation of public utility holding companies is not a uniform body of laws uniformly interpreted. During the period when holding companies were developing most rapidly the commissions were handicapped by inadequate powers and unfavorable court decisions. Although more recently their powers have been broadened and the judicial pronouncements have been more encouraging, the ability of the state commissions to deal effectively with operating-holding company relations is perhaps still less than that required for the full protection of consumers' interests, although deficiencies are notably less in some states than in others.

7. Direct regulation of public utility holding companies by the individual states, even assuming the presence of enabling legislation, is likely to encounter difficulties.[103] The mere statement of a legislature that holding companies are public utilities does not make them so; and, to state that property or business is affected with a public interest is not to determine how far regulation is permissible.[104] Both the inclusiveness of the term public utility and the degree to which a public utility may be regulated are matters for judicial review. Can it be demonstrated that a holding company which owns the stock, controls, dominates or manages a company which is a public utility thereby becomes itself a public

[103] In the subsequent discussion it is assumed that the state public service commissions would only wish to concern themselves with holding companies insofar as holding companies directly or indirectly affect the rates, service, or financial strength of operating companies serving the public. Investors' problems are scarcely their concern.

[104] "It is manifest . . . that the mere declaration by a legislature that a business is affected with a public interest is not conclusive of the question whether its attempted regulation on that ground is justified. The circumstances of its alleged change from the status of a private business and its freedom from regulation into one in which the public have come to have an interest are always a subject of judicial inquiry." Chas. Wolff Packing Co. v. Court of Industrial Relations (1923) 262 U. S. 522, 536. And on the second point: "To say that a business is clothed with a public interest is not to determine what regulation may be permissible in view of the private rights of the owner. The extent to which an inn or a cab system may be regulated may differ widely from that allowable as to a railroad or other common carrier. It is not a matter of legislative discretion solely." *Ibid.* at 539. See Tyson v. Banton (1927) 273 U. S. 418 and the cases there cited. The dissenting opinions of Justices Holmes and Stone in the latter case are most interesting and seem to foreshadow the decision in Nebbia v. New York (1934) 291 U. S. 502, 536, where Mr. Justice Roberts, after reviewing the earlier cases, wrote: "It is clear that there is no closed class or category of businesses affected with a public interest, and the function of the courts in the application of the Fifth and Fourteenth Amendments is to determine in each case whether circumstances vindicate the challenged regulation as a reasonable exertion of governmental authority or condemn it as arbitrary or discriminatory. . . . The phrase 'affected with a public interest' can, in the nature of things, mean no more than that an industry, for adequate reason, is subject to control for the public good."

utility? Mere stock ownership itself does not make a holding company a public utility; there must be something more.[105]

As one writer has expressed it:

> "The fact situations which have led the courts to disregard the corporate entity may be thus classified: *first,* where it is used as a means of perpetrating fraud; *second,* where a corporation is organized and operated as a mere tool, or business conduit of another corporation; *third,* where the corporate fiction is resorted to as a means of evading an existing legal obligation; *fourth,* where the corporate fiction is employed to achieve or perpetuate monopoly; *fifth,* where the corporate fiction is used to circumvent a statute; *sixth,* where the corporate fiction is relied upon as a protection of crime or to justify wrong." [106]

Only the second, third, and fifth of these would seem to be especially relevant to the problem of state jurisdiction of public utility holding companies. If the domination of the subsidiary by the holding company is so full and complete as to make the subsidiary a mere adjunct or agency of the parent, then the courts are likely to disregard the corporate entity.[107] In tort cases the rule is generally to overlook the corporate entity and charge the parent with responsibility for the acts of its subsidiary. If, however, the question at issue is the right of a state to sue, to regulate or to tax the parent, the corporate personality may or may not be upheld. As one writer states:

> "Speaking generally, the most that can be said with confidence is this: ownership of a large amount or a majority of the stock of a corporation does not alone reduce the subsidiary to a state of peonage which will cause its personality to be ignored. How much dictation and interference from above and how much blurring of the business and accounts is necessary in order to make it 'a mere adjunct' depends on the court and the case before it." [108]

In the case of some public utility holding companies, the amount of "dictation and interference from above" has been enormous; management and operation, financial policy, purchase of equipment, construction and other matters have been largely in the hands of the holding company. In a sense, perhaps, the holding company is undertaking to serve the public. Where the association between parent and subsidiary is so close, especially in those cases where the emphasis in the publicity

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[105] Smith v. Illinois Bell Tel. Co., *supra* note 72. In this case 99 per cent stock ownership did not warrant disregarding the corporate entity.

[106] Note (1926) 5 TEX. L. REV. 77, 78. Reproduced in REGULATION OF STOCK OWNERSHIP IN RAILROADS, H. R. No. 2789, 71st Cong. 3rd Sess. (1930) Part I, p. 9, n. 17.

[107] Western Distributing Co. v. Public Service Com. (1932) 285 U. S. 119, is a good instance of this attitude. See Greenlaw, *The Regulation of Holding Companies* (1930) 14 PROCEEDINGS ACADEMY OF POL. SCI. 108, 115–127; REGULATION OF STOCK OWNERSHIP IN RAILROADS, *supra* note 106, at Part I, pp. 10-21, where the relevant cases are cited.

[108] REGULATION OF STOCK OWNERSHIP IN RAILROADS, *supra* note 106, at Part I, pp. 20-21.

is on the "system" rather than on the individual units, the courts would perhaps be inclined to disregard the corporate entity. In fact, they have sometimes done so.[109]

The courts have disregarded the corporate personality where the purpose is evasion, either of some legal obligation or an existing statute.[110] Could the state authorities seek and obtain control over public utility holding companies on these grounds? Two difficulties seem to stand squarely in the way. First, it will be difficult to prove that the purpose for which the holding company was organized was evasion in one form or another.[111] Even if it could be shown that regulation was being defeated by holding companies, the difficulties are still great. Although the corporate entity might be disregarded, the degree to which regulation of the holding company would then be possible is still problematical.

Second, the fact that holding companies are not usually incorporated in, or doing business in, the states where their subsidiaries operate raises further legal barriers to direct state regulation. If the holding company is not incorporated in the state, and has no local agent, then the commission will encounter difficulties in taking legal action against the holding company. Unless the courts disregard the corporate entities involved, the commission is limited in its jurisdiction to the confines of the state. It is a well established rule that state courts or other agencies have no jurisdiction over foreign corporations unless they are doing business within the state;[112] and stock ownership does not as a rule constitute doing business within the state. A strong statement to this effect was made in *Selbert v. Lancaster Chocolate & Carmel Co.*,[113] where the court said:

> "In the present case, the facts that the boards of directors of the foreign and domestic corporations were interlocking, that officers of the foreign corporation occupied relatively the same offices in the domestic

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[109] *E.g.*, United Fuel Gas Co. v. Railroad Commission (1929) 278 U. S. 300; People *ex rel.* Potter v. Michigan Bell Tel. Co. (1929) 246 Mich. 198, 224 N. W. 438. But see New Hampshire Gas & Elec. Co. v. Morse (D. N. H. 1930) 42 F. (2d) 490, where the New Hampshire Commission was enjoined from demanding from a holding company seemingly relevant information concerning an operating company under the jurisdiction of the commission.

[110] The more important cases in this connection have arisen under the commodities clause of the Hepburn Act, 34 STAT. (1906) 584, 49 U. S. C. § 1 (8), and include United States v. Delaware & Hudson Co. (1909) 213 U. S. 366; United States v. Lehigh Valley R. R. (1911) 220 U. S. 257. See Chicago, M. & St. P. Ry. v. Minneapolis, etc. Ass'n (1918) 247 U. S. 490; Miller v. City of Milwaukee (1927) 272 U. S. 713.

[111] REGULATION OF STOCK OWNERSHIP IN RAILROADS, *supra* note 106, at Part I, p. 21.

[112] Greenlaw, *op. cit. supra* note 107, at 127–9. The relevant cases on this point are cited in 73-A UTILITY CORPORATIONS, *supra* note 5, at 180, n. 105.

[113] (C. C. A. 6th, 1928) 23 F. (2d) 233, 235. See Greenlaw, *op. cit. supra* note 107, at 129.

> corporations, that the foreign corporation was vitally interested in the success of the domestic corporations, or even that the foreign corporation was specifically organized to acquire and hold stock in the domestic corporations and through stock ownership to supervise, manage and control the business of such domestic corporations, or all combined, are insufficient to support the inference that the foreign corporation has subjected itself to local jurisdiction, or that it is by its duly authorized officers and agents here present."

If this doctrine continues to be upheld the state commission will have difficulty in maintaining that holding companies are doing business in the state. Furthermore, process cannot be served on a holding company through its subsidiary even though the domination of the subsidiary is complete.[114]

V

FEDERAL REGULATION

Judged by its probable results The Public Utility Holding Company Act of 1935[115] is perhaps one of the most important measures passed by Congress in recent years. As enacted, the bill endeavors to supplement the general program of security regulation inaugurated by the Roosevelt administration; to provide a corrective for certain abuses in the public utility industry; and to establish a more effective regulation of utility operations than was possible so long as regulation was undertaken solely by the states.

1. For the purposes of the Act a holding company is defined as a company (1) owning ten per cent or more of the voting stock of a public utility company,[116] or (2) any person which the Securities and Exchange Commission finds on investigation exercises "such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such persons be subject to the obligations, duties, and liabilities imposed in this title upon holding companies."[117]

The law specifically states, however, that a holding company is exempt from the provisions of the Act if (1) it and its subsidiaries are incorporated in and carry on their business within one state, or (2) it is primarily an operating company in contiguous states, or (3) its subsidiaries are outside the United States, or (4) it is only incidentally or

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[114] Peterson v. Chicago R. I. & P. R. Co. (1907) 205 U. S. 364. Greenlaw also cites St. Louis Southwestern Ry. v. Alexander (1913) 227 U. S. 218, and Philadelphia & R. Ry. v. McKibbin (1917) 243 U. S. 264, to the same effect.

[115] 49 STAT. (1935) 803, 15 U.S.C. 79-79z-6. The Public Utility Holding Company Act will hereinafter be cited merely by section.

[116] This is in accord with the definition of an "affiliated interest" in recent state legislation. Marlett and Traylor, *op. cit. supra* note 85, at 180.

[117] §2 (a), par. 7.

temporarily a holding company. The Commission may make specific rules exempting any group or class of persons from the provisions as long as such exemptions are not contrary to the purposes of the Act.

2. The Act deals a final blow at holding companies which would endeavor to profit at the expense of their operating subsidiaries. Servicing arrangements conducted directly by holding companies are prohibited entirely; although service or construction companies subsidiary to a holding company or "mutual service" companies are still permitted, their operations, including the allocation of costs and revenues, are under the control of the Commission.[118] Contracts between operating companies and wholly independent service and construction companies are also subject to Commission regulation, if deemed necessary.

Section 12 of the Act institutes a very thorough control over intercompany transactions between companies in the same holding company system. "Up-stream" loans are absolutely prohibited; while loans by a holding company to its subsidiaries are subject to commission control. Dividend payments by holding companies and their subsidiaries are only possible when they conform to:

> ". . . such rules and regulations or orders as the Commission deems necessary or appropriate to protect the financial integrity of companies in holding-company systems, to safeguard the working capital of public-utility companies, to prevent the payment of dividends out of capital or unearned surplus, or to prevent the circumvention of the provisions of this title or the rules, regulations or orders thereunder."[119]

Presumably the section just quoted gives the Commission power, if it so desires, to prevent holding companies from forcing their subsidiaries to pay injudicious dividends, or dividends from other than earned surplus. Dividends by holding companies themselves are to be similarly regulated.[120] The sale of securities or assets by utility companies, "including the consideration to be received for such sale," is subject to the Commission's control.

3. For holding companies the Commission may require uniform accounting systems. Under the provisions of section 15, the Commission has power to require holding companies, their affiliates, mutual service companies and independent service or construction companies to "make,

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[118] Separate incorporation of service companies is probably to facilitate the determination of cost. A uniform system of accounts for service companies has already been accepted.

[119] §12 (c).

[120] By a ruling of December 7, 1936, effective January 1, 1937, the dividend payments are restricted as follows: "Except upon application to, and approval by order of, the Commission, no registered holding company or subsidiary company thereof shall declare or pay any dividends on any security of such company out of capital or unearned surplus other than a dividend in liquidation of a subsidiary, all of whose securities are owned by the recipient." S. E. C. HOLDING COMPANY ACT RELEASE, No. 460 (Dec. 7, 1936) 2.

keep, and preserve" their accounting and other records as the Commission sees fit.[121] Section 15 (e), moreover, makes it unlawful for such companies to keep any business records other than those prescribed, unless the Commission approves. The Commission may prescribe uniform accounting systems for the kinds of companies named above;[122] the Commission may make any special investigations of accounts or records it deems fit. If thought advisable, the Commission may permit the examination of the business records of companies subject to the Act by (1) the holder of any security of a holding company or of any of its affiliates or subsidiaries; or, (2) by member companies of, or companies served by, a mutual service company.[123]

4. Sections 6 and 7 of the Act institute a very thorough control over the security issues of holding companies and their subsidiaries. Subject to certain unimportant exceptions,[124] no holding company or a subsidiary

[121] Section 20 (a) amplified further the kind of information and its manner of presentation as follows: ". . . the methods to be followed in the keeping of accounts and cost-accounting procedures and the preparation of reports, in the segregation and allocation of costs, in the determination of liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, . . . and in the keeping or preparation, where the Commission deems it necessary or appropriate, of separate or consolidated balance sheets or profit and loss statements for any companies in the same holding-company system."

[122] Section 20 (b) states that where a company's accounting methods are prescribed by any state or federal law the Commission's rules and regulations "shall not be inconsistent"; but the Commission may impose additional requirements. In September, 1936, the Commission announced its "Uniform System of Accounts for Public Utility Holding Companies." S. E. C. HOLDING COMPANY ACT RELEASE, No. 349 (Sept. 8, 1936). The most interesting points of the system perhaps are the following: investments carried at cost, differentiation of different kinds of surpluses; undistributed earnings of subsidiaries may not be taken up; stock dividends may not be taken into income or surplus at more than that charged by the paying companies to their income or earned surplus accounts.

[123] Section 22 provides that the Commission may make public any information filed with it which it believes would be in the interest of the public, investors, or consumers. Persons filing information, however, may object to certain things being made public and the Commission may consider the objections and act accordingly.

[124] Briefly the exceptions are (1) short-term borrowings where there is no public offering and which mature within, or are not renewed for longer than nine months; which do not amount to more than 5 per cent of the par or principal amount of the outstanding obligations. (2) The Commission "by rules and regulations or order, subject to such terms and conditions as it deems appropriate in the public interest or for the protection of investors or consumers, shall exempt" (i) security issues of subsidiaries when solely for the purpose "of financing the business of such subsidiary company and have been expressly authorized by the State commission of the State in which such subsidiary company is organized and doing business"; or (ii) "if the issue and sale of such security are solely for the purpose of financing the business of such subsidiary company when such subsidiary company is not a holding company, a public utility company, an investment company, or a fiscal or financing agency of a holding company, a public utility company, or an investment company." (3) If the security is issued under the terms of any security issued and outstanding on January 1, 1935; *i.e.*, conversion and option warrant privileges, *etc.*

thereof may (1) issue securities, or, (2) exercise its right to alter the priorities, preferences, voting rights, or other rights of any of its outstanding securities, without filing a declaration with the Commission. The declaration must include the information required under section 7 of the Securities Act of 1933 and such other information as the Commission may require. But the Commission is required to do more than enforce complete publicity of all relevant data. In effect, the Commission must also approve the kind of security to be issued, its purpose, and its effect upon the financial structure and earning power of the company. Section 7 (c) specifically states that the Commission shall not permit a declaration to become effective unless it finds that:

> "(1) such security is (A) a common stock having a par value and being without preference as to dividends or distribution over, and having at least equal voting rights with, any outstanding security of the declarant;
>
> "(B) a bond (i) secured by a first lien on physical property of the declarant, or (ii) secured by an obligation of a subsidiary company of the declarant secured by a first lien on physical property of such subsidiary, or (iii) secured by any other assets of the type and character which the Commission by rules and regulations or order may prescribe as appropriate in the public interest or for the protection of investors;
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> "(C) a guaranty of, or assumption of liability on a security of another company; or
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> "(D) a receiver's or trustee's certificate duly authorized by the appropriate court or courts; or
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> "(2) such security is . . . for . . . refunding, exchange, [*etc.*] . . . or for . . . effecting a merger, consolidation, . . . [*etc.*]; . . . or for . . . financing the business of the declarant as a public utility. . . .
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> "(3) such security . . . was authorized . . . prior to January 1, 1935 and which the Commission . . . authorizes as necessary or appropriate in the public interest for the protection of investors or consumers."

Furthermore, the Commission may not approve the issue if in its opinion the security issue is (1) not reasonably adapted to the financial structure; (2) unsuited to the earning power; (3) inappropriate or unnecessary to economical and efficient operation; (4) the fees and commissions are unreasonable; (5) if the guaranty or assumption of liability are an improper risk; (6) "the terms and conditions of the issue or sale of the security are detrimental to public interest or the interest of investors or consumers." Finally, in permitting any security declaration to become effective the Commission may impose such terms and conditions as it finds necessary.[125]

[125] Literally interpreted the foregoing provisions almost require the Securities and Exchange Commission to dictate the capital structure of registered public utility holding companies. As already noted, these sections of the Act do more than require complete publicity; they demand a thorough investigation of the financial soundness and social desirability of each issue. If interpreted rigidly, they give the Commission more than sufficient power to eradicate the evils and weaknesses of overcapitalization, excessive pyramiding, concentrated control, *etc.*, discussed above.

5. Sections 8 to 11 inclusive of the Act of 1935 endeavor to regulate the acquistion of utility assets and securities, and to simplify holding company structures as they now exist. With certain exceptions[126] any company subject to the Act which proposes to acquire securities or utility assets must file an application with the Commission giving full details. In passing upon such applications the Commission shall first see that all state laws are met;[127] but before granting approval the Commission must apply certain tests as follows: (1.) Will the proposed acquisition promote "interlocking relations of the concentration of control of public-utility companies" contrary to the interest of the public, investors, or consumers? (2.) Are the fees incidental to the acquistion too high? (3.) Will the capital structure be unduly complicated contrary to the interest of the public, investors, or consumers? Even if all these tests are satisfactorily met the Commission may not approve the application if such acquisition permitted gas and electric companies in the same locality to be combined (unless the state authority approves), or prevented simplification of holding company systems, or failed to serve "the public interest by tending towards the economical and efficient development of an integrated public-utility system."[128] The wording of these sections

[126] The provisions do not apply to security or asset purchases if a state commission has approved, or, if the business of the companies in question "and all other public-utility companies in the same holding-company system" are organized and do business chiefly in that state. Government securities or securities and commercial paper bought as an investment for current funds are exempt. See §9 (b) and (c).

[127] The wording here (Section 10 (f)) is a little peculiar: "The Commission shall not approve any acquisition . . . unless it appears . . . that such State laws as may apply in respect of such acquisition have been complied with, except where the Commission finds that compliance with such State laws would be detrimental to the carrying out of the provisions of section 11." Section 11 applies to the simplification of holding company systems. Does this mean that the Commission will approve even where state laws will be violated?

[128] §10 (c) (2). The General Counsel of the Commission has given his opinion of the meaning and interpretation of this section as follows: "So far, therefore, as Section 10 (c) (2) is concerned, I have been authorized to state that any acquisition which makes for the economical development of the property acquired as an efficient and self-sustaining operating unit or system may be regarded as 'tending towards the economical and efficient development of an integrated public-utility system,' and that it is not essential that the property acquired by [be?] interconnected or capable of inter-connection with some other property under the control of the company making the acquisition. This does not mean, of course, that the Commission may not disapprove a particular acquisition if the Commission finds, for example, that it may block an economically desirable merger of adjoining properties or that it has been undertaken for some strategic or other purposes which are not conducive to the efficient operation or upbuilding of the property acquired." S. E. C. HOLDING COMPANY ACT RELEASE, No. 54 (Dec. 23, 1935) 3. This is much more liberal than the Act itself would suggest. In *ibid.* at p. 4, dealing with reorganizations and simplification, it is stated, "But there is nothing in the terms of the Act which would prevent the Commission from sanctioning the acquisition by a reorganized company or several integrated systems in different

suggests that the framers of the Act intended that capital structures should be simplified and that the Commission should create "an integrated public-utility system;" for these are the principles which shall guide the Commission in passing upon security and asset acquisitions. But perhaps the most drastic clause is that which reads:

> "The Commission, in any order approving the acquisition of securities or utility assets, may prescribe such terms and conditions in respect of such acquisition, *including the price to be paid for such securities or utility assets,* as the Commission may find necessary or appropriate in the public interest or for the protection of investors or consumers."[129]

Section 11 indicates the kinds of changes which the drafters of the bill feel must be brought about in the holding company system. Their aim is the abolition of complicated corporate structures and inequitable distribution of voting power. Furthermore, they strongly favor integrated public utility operations. They seem definitely to reject the notion that geographically separated operating units under one control are desirable.

As soon as practicable after January 1, 1938, the Commission is required to issue orders seeking the accomplishment of two ends, *viz.*:

> "(1) . . . to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: . . .
>
> "(2) . . . to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. . . ."[130]

The reorganization plans to carry out these changes[131] may be suggested either by the company, any interested party, or by the Commission. The Act allows not longer than two years to carry out any orders

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localities or regions if the result of the acquisition were merely to bind together under common control companies or properties previously under common control and no others . . ."

[129] § 10 (e). Italics supplied.

[130] §11 (b). The Commission may permit a registered holding company to retain control of more than one integrated utility system if it finds that to break them up would be uneconomical, or, that they are all in one state, or that the combination is not so large as "to impair the advantage of localized management, efficient operation, or the effectiveness of regulation." See *supra* note 128.

[131] Up to the spring of 1936 no formal action had yet been taken under these provisions, according to a letter from the Secretary of the Commission to the writer.

for reorganization which the Commission may make. To carry out the reorganization plans the Commission may apply to a federal court and have itself appointed a trustee or receiver, and furthermore, "the court shall not appoint any person other than the Commission as trustee or receiver without notifying the Commission and giving it an opportunity to be heard before making any such appointment."[132] Any reorganization plans, therefore, are to be under the full direction of the Commission.

VI

In effect the Holding Company Act is both a supplement to state regulation of public utilities and a further step in the program of securities regulation. It rejects the theory of the Securities Act of 1933 that complete publicity of all relevant data will adequately protect the interests of investors and the general public. Under this Act the Securities Exchange Commission is required to approve certain issues and disapprove others. The principles on which the Commission is to grant or withhold its sanction are partially indicated: no-par value shares are forbidden; non-voting shares likewise; bonds must be secured by a first mortgage, the collateral of first mortgage bonds, or such other pledged assets as the Commission may approve. But the Commission must do more than this; in effect, it must function as the manager of the enterprise and as its investment banker. For in passing upon proposed issues the Commission must consider their effect on the capital structure of the enterprise, their relationship to its earning power, the reasonableness of the fees and terms of sale, and finally the actual need of the corporation for the additional funds. The Act does not indicate, however, what constitutes an "unduly" complicated capital structure, a "proper" ratio between charges and earnings, "reasonable" fees and commissions, or the tests which determine the "necessity" of more capital. Nor is it easy to specify acceptable definitions for any of these things; they are matters of judgment where competent authorities would differ. If the Commission interprets and applies these provisions (section 7) literally, each new issue will require an enormous amount of study and investigation; while the delays and confusions will react unfavorably upon the efficiency and flexibility of the companies. If utility financing should approximate its pre-depression levels, the disorder and cumbersomeness of the whole arrangement might become appalling. It is conceivable, of course, that the Commission will interpret these portions of the Act less strictly. In that event the Commission is almost certain to approve some unsound issues which, when proven so, will lower its prestige. In its administration of the Securities Act of 1933 the Commission has been at great pains to

[132] §11 (f).

emphasize that it passes no judgment upon the investment merits of appropriately registered issues. To do otherwise for public utility securities, in the writer's opinion, will confuse the public and discredit the Commission. It is unreasonable to suppose that any agency can properly pass judgment upon the investment merits of the security issues of even one industry with efficiency and dispatch in so large a country as the United States.

The abuses of the corporate system and the instruments of corporation finance, which developed in the post-war years, crept into the utility industry as well as others. But it is doubtful if they were more virulent here than in banking, investment trusts, or real estate. In the utilities these abuses have been partly a consequence of the growing separation of ownership and control and partly a by-product of extraordinarily rapid growth. While a few holding companies entirely escaped criticism from the official investigators, the number of companies which seriously abused their power in many directions is not large.[133] Certain practices, such as profitable service contracts and excessive pyramiding which were peculiar to the industry and more or less general, are definitely outlawed. Others, such as non-voting shares, unsound dividend policies, complicated capital structures, *etc.*, which are to be charged to the weakness of our corporation laws and were more or less common in all industries, will henceforth be unlawful for public utility holding companies.

The Act of 1935 postulates the necessity of important changes in the relationship of utility operating companies to one another. As originally drafted the Act provided for the complete elimination of all utility holding companies by January 1, 1940, but as enacted, holding companies are permitted to remain provided no more than three corporate steps are present in any pyramid. The Act lays much stress furthermore upon the desirability of "integrated utility systems." The theory here seems to be that all interests will be better served if the electric companies in a given region are interconnected and under a common management.[134] Whether these regions are to be conceived on the basis of "natural" boundaries, population centers, or on some other principle is not indicated.[135] There is an implication, however, that the regional boundaries are the borders of the states. But whether it is believed that the states configurations

[133] The companies usually cited in this category are the Insull group, Central Public Service Corporation, Associated Gas & Electric, Electric Bond & Share, Cities Service, and possibly Standard Gas & Electric Co. Altogether these represent perhaps one-third of the electric power industry.

[134] It is worth noting that the Act denies the advisability of gas and electric companies in the same region being under one control. The writer has found no explanation or defense of this position by the proponents of the bill.

[135] The Duke Power Co. system and the Hartford Electric Light Company were cited by Commissioner Splawn with much commendation.

provide natural power regions in any technical sense, or merely that this is the most practical arrangement from the standpoint of regulation, is not specified. Furthermore, the conclusion that integrated utility systems are necessary and desirable, is at least debatable.

In the hearings on the bill, Commissioner Splawn emphasized that the electric industry was primarily local in the sense that long distance transmission was not feasible. From this fact it was argued that the management must be locally resident and that the holding company was little more than an undesirable excresence.[136] Local management is probably necessary for routine operatious; but for larger engineering problems and the raising of capital holding company affiliations may prove extremely valuable. The proponents of the bill argued that the ability of the holding companies to raise the capital was dependent upon the inherent soundness of the operating companies, which could have raised the capital themselves on equally favorable terms.[137] This is perhaps true of large operating companies. It has not been historically true, and it is apparently not now true, that the smaller companies, without holding company affiliations, are well enough known in the financial centers to borrow capital easily and cheaply; and there is the further problem of small issues.

The fact that certain holding companies were growing so large that it was impossible for any agency to regulate them seems also to have been responsible for the insistence on smaller, regional groupings.[138] There may also have been an inherent distrust of size *per se*; we are more conscious now than ten years ago of the dangers and diseconomies of size.

The ultimate effect of the Act upon state regulation is difficult to determine. The events and investigations preceding the bill seemed to emphasize the inability of the states to deal effectively with the holding company problem. Nevertheless, state regulation has become increasingly effective in the last six years. There has been a belated realization of the holding company problem. State legislatures have strengthened the powers of their commissions by new legislation. Larger budgets are available to the commissious, provided in part by direct assessments against the companies. Finally, the federal courts, in recent important decisions, have removed certain legal barriers which previously hampered

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[136] House Committee on Interstate and Foreign Commerce, HEARINGS ON H. R. No. 5423, 74th Cong. 1st Sess. (1935), especially at p. 180. See Splawn, *Is the Power Holding Company Necessary?* (1933) 9 J. LAND AND PUB. UTILITY ECON. 226-233.

[137] HEARINGS ON H. R. No. 5423, *supra* note 136, at 64, 70.

[138] *Ibid.* at p. 186.

the commissions. It is noteworthy that the National Association of Utility Commissioners believed the states were capable of dealing with the holding company problem insofar as it impinged upon effective regulation of public utilities. The commissioners were most anxious, however, that the bill confine itself to problems beyond their control or their functions; they heartily endorsed the general purpose of Title II, which grants the Federal Power Commission jurisdiction over interstate transmission of electric power. But they were openly apprehensive that the bill as originally drafted might transfer to the federal government too much control over strictly intrastate problems.[139]

If the changes contemplated by the bill concerning regionally-integrated systems on state lines come to pass, it is conceivable that most holding companies, being predominantly intrastate, would be exempt under the Act, and henceforth all regulation of utility operations would fall to the state authorities. Thus in a few years the Holding Company Act of 1935 might possibly cease to be of practical importance.

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[139] Statement and testimony of John E. Benton for the National Association of Railroad and Utility Commissioners in *ibid.* at pp. 1620–1695. Also in Senate Committee on Interstate Commerce, SENATE HEARINGS ON SEN. No. 1725, 74th Congress, 1st Sess. (1935) 746–794.