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THE FUTURE OF THE INTERSTATE POWER HOLDING COMPANY

Analysis of Wheeler-Rayburn Bill, Designed to Regulate Corporate Family; "the Only One Known Which Can Keep Alive Nine Generations Contemporaneously," With a Recommendation for Adjustment of the General Incorporation Laws Also.

BY: PROF. WILEY B. RUTLEDGE

Dean, College of Law, Washington University

The Wheeler-Rayburn bill now pending in Congress, provides for practically complete dissolution of interstate power holding companies by 1940 allowing the intervening period for transition. Exception is made for the continuance of "geographically and economically integrated systems," which by reason of special circumstances can present proof of need for their existence. Some administrative discretion is allowed for extension of the period within which dissolution must occur, when special considerations dictate this.

The proposed act does not represent snap judgment. It is the result of more than five years of investigation by the Federal Trade Commission and other bodies, whose recent reports to Congress furnish strong support for the bill in the assembled facts. The underlying theory is that the holding company combines the evils of national or near-national monopoly, with absentee ownership, almost unlimited possibility for financial manipulation, and practically complete immunity from effective public regulation.

Two Fundamental Objections To the Holding Company

Two fundamental elements appear in this theory. One is opposition to the concentration of the industry, through replacement of independent local units by systems of national or nearly national scope. The other, closely connected with the first, but to be differentiated clearly, is the fact that the holding company involves such immense possibilities for financial and managerial

abuses that it should go. Both of these conceptions appear in the President's message submitting the bill to Congress. He thinks the control and the benefits of "the essentially local operating utility industry" should be taken "out of a few financial centers" and given back "to the localities which produce the business and create the wealth." He also thinks the abuses so gross and so "inherent in its very nature" that the holding company no longer should "be tolerated as a recognized business institution."

Defenders of the system dispute the truth of the premises and deny the conclusion. Admitting abuses, they advocate their elimination, but only by methods which will preserve the system's essential integrity. The argument takes two forms. Stronger in immediate appeal is the "salvage" argument, which urges that termination would work irreparable injury to present holders of holding company securities. The extreme of this viewpoint was stated recently by a utility official testifying before the House Committee on Interstate Commerce: "The mathematical procedure is too complicated to permit the distribution of the company's holding pro rata among the stockholders, and the raising of cash for distribution would entail loss of most of the value of the company's assets." If the statement is true it is practically an admission that these securities reflect no real value presently except that which comes from the mere fact of combination and control of the operating companies. In that case, the argument becomes a smoke-screen to prevent the disclosure of a vast over-capitalization. In so far as the statement is not in accord with the facts, the argument fails. In any event, however important it may be to protect him so far as is consistent with the welfare of other interests, the present investor is simply one element in a complex of interests affected by the holding company system. Certainly he cannot claim to have the future national policy _____

_____ of his protection and without regard to the interests of the customer, the future investor and the community as a whole.

Argument That System
Has Justified Existence

The second argument is more far-reaching. It is that the holding company has earned immortality upon its merits. It is responsible, so it is said, for the vast expansion in power consumption since 1910, when it first became a significant force in the power field; It has produced large economies in operation and lowered consumer costs. In spite of the Insull and other crashes, it is said to offer greater investment security, because "holding companies, through intentional wide separation of their units, are able to diversify their operations and minimize the effects of business fluctuations." In other words, utility concentration is sound in economic principle and the holding company is the best instrumentality for creation and maintenance of the large unit system.

It is true that during the 25 years of holding company domination, there has been a great expansion of power service; that on the whole, with some notable exceptions, the quality of service has been satisfactory; that in general the cost per unit of power to the consumer has been reduced. The notion that the holding company makes for investment security in the public utility field simply is nullified by the facts. The idea that it is responsible for the progress in other respects ignores important facts. Certainly technical advances in engineering management and general business methods, quite apart from their exemplification in the holding company, have had much to do with this progress. Also, on the whole the quality of service rendered by municipal and independent operating units has been as good as that of the holding company system. Probably, also, these units supply service at rates as low as, if not lower on the average, than those given by holding companies. It has not been demonstrated that the national power

unit is more efficient, and in some respects it may be less efficient, than the regional or local unit.

Hard to Discover any Advantage to Investor

It is difficult to find any clear advantage which has come through the holding company for the investor, the general consumer or the public which could not have been created through direct purchase of physical assets or the processes of merger and consolidation. It is true that these methods of combination are slower and that they face some legal obstacles which the holding company so far has been permitted to surmount. But it is questionable whether the slower methods would not have created a sounder and more enduring structure, and whether the courts have not nullified important statutory policies by constructions which permit evasion by the holding company of restrictions imposed upon combination by the laws governing merger and consolidation.

There is no doubt that the holding company is most pliable and facile instrumentality for the concentration of wealth and economic power which history has devised. Within 25 years it has assembled into national systems 80 per cent of all power distributed in the United States. In the power field it has issued more than two billion dollars in securities, controlling thereby investments of 10 billion dollars in operating companies. Prior to 1929 a single company, with $750,000,000 capitalization, had control of corporations with over three billion dollars in assets, and capitalists dominated the holding company with less than $300,000,000 invested. The holding company has accomplished what the “corner”, “the pool” and the “trust” of previous generations sought, but were unable to achieve.

A perversion, rather a mere abuse of the original state laws which gave it being, with the acquiescence and eventually in some cases the positive aid of the state legislatures and courts, it

has set at naught the national policy as expressed in the Sherman Antitrust Act. No other instrumentality would have produced in the same time the degree of consolidation and concentration which it has accomplished. Unchecked, its possibilities for future expansion are almost unlimited.

It is too early to determine generally whether our future economic system will be composed primarily of units approximating national scope or of units local or at most regional in extent. Certainly the trend has been constantly toward the larger unit, and the writer believes this will continue. If we are to return to a smaller unit system, the obvious place to begin is with the holding company. But if the tendency toward the large unit continues, the question for the immediate future will have to do with specific industries. In some fields, notably in communications and transportation, the requirements of modern life dictate the national or nearly national unit.

Reasons National System Does Not Apply to Power

However, in view of the present limitations upon the transmission of power, especially in the form of electrical energy, it is not apparent that this is true of the power industry. There is no operating reason for connecting plants in Colorado with others in Missouri, Illinois and Maine. There are considerations which make regional units desirable, but none save purely financial reasons which require national units. The regional and local units seem to supply the logical instrumentality and probably the most efficient for this industry. It is susceptible, also, to local regulation in greater degree, and for that reason should appeal to those who favor local self-government and fear the development of Federal bureaucracy.

The writer believes that the second element in the President's policy constitutes the stronger reason for dissolution of the holding company system. Whether the future economic

organizations will be composed of large or small units, the abuses which have characterized the operation of holding companies must go. It has brought with it a train of corporate perversions, some inherent in its structure, others of general corporate application which it has magnified by the scope of its operations. The period of its development has seen the invention and acceptance by State legislatures, in some cases at its behest, of such speculative devices as no-par stock (removing one of the few remaining guaranties of honest capitalization); the stock dividend (by which paper surpluses are converted into the illusion of additional holdings or the reality of additional speculative opportunities, and by which also the payment of real dividends has been avoided); non-voting stock, preferred and common (by which the so-called "owner" was stripped of even the semblance of voice in determination of major policies); "rights" and other unusual types of "participations" (which are neither stock nor bonds, fish nor fowl, but almost water-proof opportunities to share in the profits of market advances in stock,) etc. All of these devices have been employed by power holding companies, probably to a larger extent than by any other industry.

"Writing Up and Down"
Companies' Capitalization.

If the holding company did not invent, certainly it magnified the evil of over-capitalization. It is possible by pyramiding company upon company to capitalize $1000 in physical assets through successive stock issues, each based upon the nominal or par, market or book values of the stock held in the underlying company, for several thousand dollars. The genius of an Einstein could not determine the ultimate limits of this process, which is inherent in, and peculiar to the holding company. In some instances, due to the intense competition during the booming twenties between distinct systems for stocks of operating companies, prices were paid running from 100 to 150 times the book values of these shares. The holding company, of

course, capitalized them at cost to it. In response to pressure from utility interests, many states have created other opportunities for "watering" by passing provisions which make the judgment of the directors conclusive on the question of the valuation of property for the purpose of capitalization, and some permit revaluation by them from time to time as they see fit. Theoretically justified as a method of bringing capitalization into correspondence with actual values, the latter provision offers unlimited opportunity for "writing up" or "writing down" capitalization in accordance with the speculative imagination of the controlling group.

Concentration of Control Made Easy for the Few.

Combined with over-capitalization has been the abuse of direct security manipulation. The Insull disclosures in this respect are fresh in the public memory. According to a recent report of the Federal Trade Commission, in the period from April 21, 1927, to Dec. 21, 1930, another system sold to the public the equivalent of 41,488,512 shares of present no-par common stock for $1,146,516,779.17. During the same period it bought 34,051,927 shares for $956,710,037.65. The commission says the net result of these operations was to obtain $80,711,657.37 new capital for 5,649,997 shares of new original issues. The sale and purchase of more than a billion dollars' worth of securities to obtain less than one-tenth that amount of new capital, would seem to the ordinary observer little less than insane. But it was not as foolish as it appears. Under the guise of "protecting the market", the manipulation ran up the price prior to October, 1929 and thereafter operated to sustain the bloated values. It would be interesting to know who profited and how much. At any rate, the "outside" investor (the "customer owner" and the "employee shareholder") was subjected to the double hazard of vast initial over capitalization and subsequent market operation with his own money.

The holding company supplies the largest opportunity for concentration of control. The devices of share dispersion, non-voting stock, the voting trust etc., are available generally to corporations. But the holding company, by utilizing them, both in the subsidiary corporate structures and in that of the holding company (especially when the system includes the "intermediary" company), multiplies the power to concentrate control almost in geometric progression. In the independent corporation, through wide share dispersion, ordinarily 20 to 25 per cent of the voting stock can control the company. By skillful use of the holding company system, this percentage can be reduced to ten per cent or less.

Keeping Nine Generations Alive At The Same Time.

Further opportunities for manipulation, in securities, in credit relations and in rate-making, are supplied by the possibility of intercorporate relations among the various units constituting the system. Each unit, including subsidiaries, "parents", "grandparents," and "great-grandparents," as well as "investment affiliates," is considered legally as a "separate entity". This is true for most purposes, even though the respective directorates are composed of the same men. "Upstream loans," "service charges", and "contracts" generally, made by these officials acting on both or all sides of the transaction, supply infinite opportunities for inter-corporate manipulation. In this way liabilities, even in tort and crime are segregated among the various units. The maze of "contracts" and of accounts is so intricate that no outsider (and probably few "insiders") can determine real costs or profits. Rate-making becomes a farce, and the balance sheet of the system a puzzle worse than Chinese. The corporate family is the only ones known which can keep alive nine generations contemporaneously. In some cases the holding company takes a percentage of the gross returns of the operating company in exchange for "services"-- a splendid method of showing a profit even though all subsidiaries may be operating at a loss.

While the courts have created some restraints upon the "separate corporate entity" idea, generally these apply only in unusual situations. Nevertheless this possibility creates a tremendous volume of litigation, which a simpler system would avoid.

Effective in Evading Public Regulation.

The holding company has been most effective, perhaps, in evasion of public regulation. Generally it is incorporated in a state other than that in which the operating company carries on its business or is incorporated. Consequently, it is almost universally beyond the direct control of the local regulatory body which has jurisdiction of the subsidiary. Regulatory power is divided between the two or more states. This creates endless opportunity for litigation. Jurisdictional problems arise which in practical effect nullify much of the attempt at regulation. No state has adequate laws for regulating the issuance of holding company stock. Ordinarily "blue-sky" laws exempt public utility securities when the operating companies are under regulatory control.

In various ways the holding company defeats effective regulation of operating companies. By public 'education," penetrating even the public schools, and "customer ownership," it lessens the demand for rate reduction. By financial support of litigation involving ratemaking and other problems of operating companies, it delays final determination almost indefinitely. When it is made, as frequently as otherwise it is out of date. By so-called "service" charges (profits or dividends upon its holdings are not sufficient to satisfy its appetite), it adds to the cost of service, and in many cases reasonableness of the charge can be determined only by an examination of the accounts of the entire system. The intricacy of the system of costs, requiring the tracing of items from company to company and involving the difficulty of apportioning them properly, especially overhead charges among the various units, makes it practically impossible

for any local or state commission, with the usual limited accounting assistance and jurisdictional limitations, to find the truth of the matter. The combination of a nation-wide holding company and state "regulation" is almost ideal for evasion of public control. Such regulation would be a comedy, if it were not so tragic.

Evasion of Anti-Merger
Statutes Made Simple.

The holding company also offers a ready means for evasion of the statutes regarding mergers and consolidations. These laws recognize the need for reasonable industrial and business combination, but they also surround it with reasonable safeguards to protect the public, the creditor's and the investor's interests. The holding company evades the restrictions completely. Likewise, state laws in some cases limit particularly valuable privileges, such as that to employ the power of eminent domain, to domestic or local corporations. By organizing a local subsidiary, the foreign company technically meets these requirements (under a perverted judicial construction usually involving the "separate entity" notion), but substantially evades them. Other like instances are numerous.

These abuses, in the writer's view, far outweigh any advantages which may be attributed exclusively to the holding company. Some of them are not inherent in the holding company. They are available to all corporations, and the holding company has taken advantage of them as might be done by an independent operating company. But even in these instances, by the very scope of its operations it has magnified their effects. Administrative regulation and amendment of state incorporation laws could control some of these matters, but it is useless to expect charter-selling states to give up their fees, and administrative control is hampered by jurisdictional conflicts and uncertainties. Even if co-operation could be secured from the states or if Congress had plenary power over state corporations engaged in inter-state commerce, the very amount of

regulation required to eliminate the major abuses would be more cumbersome and bureaucratic than would a reorganization of the system.

Manipulation of Stocks Of Subsidiaries Is Easy.

But the most insidious abuses are those which are inherent in the holding company set-up. These are the possibilities which are created by the inter-corporate connections of the system. The possibility of stock manipulation is extended not only to the holding company's own security issues, but also to those of its subsidiaries. Ghostly contracts, fictitious investment structures, intricacy and complexity of accounts with resulting concealment of costs, and invasion and segregation of liabilities, as well as division of regulatory power and otherwise unattainable concentration of control, are innate in the system. No legislation can be devised which will eliminate the possibility of these abuses and preserve the essential integrity of the present system. Because no system can survive with such concerns consuming it, the writer believes the principle of the Wheeler-Rayburn bill is sound. The President's case appears to be made on both grounds.

Some Modifications In Present Bill Suggested

However, certain modifications are desirable and undoubtedly some charges will be made. Sufficient time should be allowed to prevent the reorganization from assuming the aspects of forced liquidation. Perhaps five years is insufficient. If so, the period can be lengthened. Possibly a better procedure would be to eliminate the fixed period altogether, leaving the whole matter to be determined by administrative discretion. In this way the time for dissolution would be fixed with reference to the facts involved in each situation. In any case,

provision should be made to permit a somewhat larger discretion for extensions in particular cases than is allowed in the present bill.

The writer agrees also with those who advocate centralizing the supervisory and regulatory functions in a single commission, probably the Federal Power Commission, as against the present plan of distribution among three different bodies. The "common carrier" provisions obviously are not essential parts of the bill, and can be removed, if this is desirable, without destroying its central principle. Other changes could be suggested which would be beneficial, but these are sufficient to illustrate the types of modification which can and probably will be made.

No Losses Likely Beyond Those Under Sherman Act.

With such modifications, the bill will not be a radical bill. A strong case could be made for going further. It does not eliminate all power-holding companies. Only the unit of national or nearly national size is proscribed. Nor does it require that these be broken down into the ultimate operating units. They may be reduced to regional units, thus eliminating much of the alleged danger to the present investor. In the case of the soundly financed company or system, he would thus lose only the value, if any, which comes from the difference between a combination of regional scope and one of national extent. If the system is not soundly financed, his loss has occurred actually already, and it should be disclosed and eliminated from the present capitalization whether the Wheeler-Rayburn bill is passed or some form of the now much-desired regulation is substituted for it.

"Intermediate" companies for which it is difficult to find any justification, would go. On the whole, it is not to be expected that there would ensue greater losses for investors than those

which followed the dissolution of the Standard Oil Trust, the American Tobacco Trust, etc., under the provisions of the Sherman Act.

National Incorporation Proposed as Essential.

In one respect the writer would go further than the provisions of the present bill. It is the system of State incorporation which has produced not only the holding company, but also the whole train of speculative devices which have appeared during its lifetime in the general incorporation laws, and for which it is partly responsible. Insofar as the holding company is permitted to continue in interstate commerce, it should be required to do so by qualifying under a national incorporation act. Only by so doing can many of the conflicts of jurisdiction be eliminated. Thus only can adequate simplification of the corporate structure be achieved and preserved.

Once such an adjustment is made, the entire problem will be simplified, not only for purposes of regulation in the public interest, but also for those of executive administration of the system. During and even before 1910, when the holding company was coming into fashion, Charles Nagel, then Secretary of Commerce and Labor, Frederick W. Lehmann, former solicitor-General, and others of eminence and statesmanly foresight, ably and vigorously advocated national incorporation for all corporations engaged in interstate commerce. Had this wise counsel been followed, it is probable that the holding company would never have appeared. At any rate it could not have attained its present power. What colossal loss this might have saved the American people probably never will be known. It must not be repeated.