HOLDING COMPANY ACT - "CONTROLLING INFLUENCE"

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HOLDING COMPANY ACT — "Controlling Influence" — Most new and revolutionary statutes for the regulation of interstate trade and commerce cause both lawyers and businessmen many headaches before their terms become fixed in meaning by judicial interpretation. The Public Utility Holding Company Act of 1935¹ is no exception.

Difficult questions of interpretation are bound to arise under a statute of such a complicated nature, leaving, as it does, so much to the discretion of administrative officers. In the spring of this year the problem of what is a “controlling influence” was brought to light by two cases. While each case raised the question in a situation totally different from the other, fundamentally it was the same in each.

I.

*Detroit Edison Co. v. Securities and Exchange Commission*²

Section 2 (a) (8) of the act defines “subsidiary company” as any company ten per cent or more of the voting securities of which are held by a holding company. However, if the commission shall determine such company not to be subject to a controlling influence

² (C. C. A. 6th, 1941) 119 F. (2d) 730, cert. den. (U. S. 1941) 10 U. S. L. Week 3119, 3123.

"(A) any company 10 per centum or more of the outstanding voting securities of which are directly or indirectly owned, controlled, or held with power to vote, by such holding company (or by a company that is a subsidiary company of such holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such company not to be a subsidiary company of such holding company; and

"(B) any person the management or policies of which the Commission, after notice and opportunity for hearing, determines to be subject to a controlling influence, directly or indirectly, by such holding company (either alone or pursuant to an arrangement or understanding with one or more other persons) so as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon subsidiary companies of holding companies.

"The Commission, upon application, shall by order declare that a company is not a subsidiary company of a specified holding company under clause (A) if the Commission finds that (i) the applicant is not controlled, directly or indirectly, by such holding company (either alone or pursuant to an arrangement or understanding with one or more other persons) either through one or more intermediary persons or by any means or device whatsoever, (ii) the applicant is not an intermediary company through which such control of another company is exercised, and (iii) the management or policies of the applicant are not subject to a controlling influence, directly or indirectly, by such holding company (either alone or pursuant to an arrangement or understanding with one or more other persons) so as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon subsidiary companies of holding companies." 49 Stat. L. 807 (1935), 15 U. S. C. (Supp. 1939), § 79b(a)(8). (Italics added.)

It will be noticed that § 2 (a) (8) (B) uses the word “person.” § (2) (a) (1) of the act defines “person” as “an individual or company.” Under sec. 2 (a) (2) “company” includes a corporation, partnership, association, joint-stock company, business trust, “or an organized group of persons, whether incorporated or not; or any receiver . . . of any of the foregoing. . . .”
which can be exercised by the holding company, then the commission may by order declare such company not to be a subsidiary company.

Pursuant to this section the Detroit Edison Company applied to the Securities and Exchange Commission for an order declaring it not to be a subsidiary of the American Light & Traction Company, Gardner & Brown, the North American Company, the United Light & Power Company, or the United Light & Railways Co.

As to North American the petition was denied. It was this ruling by the commission which was in controversy before the circuit court of appeals. The court affirmed the order. North American presently owns 19.28 per cent of Detroit Edison stock. North American caused the organization of Detroit Edison in 1903. A guiding figure in this organization was Mr. Alex Dow. Mr. Dow had managed Detroit Edison's predecessors. North American paid Mr. Dow $10,000 for his services in obtaining the stock of Detroit Edison's predecessors for North American and in organizing Detroit Edison.

The record then shows a long history of intercorporate relationship between Detroit Edison and North American. Mr. Dow became president of Detroit Edison and is now on its board, although he is no longer its president. North American has at all times had directors and officers on the Detroit Edison board. Two members of Detroit Edison's present board were on the original board named by North American, while two others are directly associated with North American at the present time. The board consists of seven members.

The court stated, however, that there was no evidence that Detroit Edison was directly or indirectly controlled by North American. The commission and the court based the decision on the ground that clause (iii) of section 2 (a) (8) of the act was not complied with because the petitioner had failed to sustain the burden of proof that it was not subject to a controlling influence exercised by North American. Much weight was attached to the history of control exercised before 1935.

4 Since Gardner & Brown had disposed of its Detroit Edison stock, the petition was granted as to it, seemingly without opposition.

5 "The American Light & Traction Company is a subsidiary of the United Light & Railways Company, which in turn is a subsidiary of United Light and Power Company." 119 F. (2d) 730 at 733. These companies will be hereinafter sometimes called "United." The American Light and Traction Co. owns 20.27% of the Detroit Edison stock. However, it was shown that United has never at any time been granted representation on Detroit Edison's board, but was at all times excluded from any participation in Detroit Edison affairs. Thus the petition was granted as to United, subject to certain conditions.

6 In its opinion the court gave a detailed statement of the facts, including the history of North American-Detroit Edison relations since the latter's organization. This statement is a reasonable facsimile of the statement found in the commission's opinion. Matter of the Detroit Edison Co., 7 S. E. C. 968 (1940).
Detroit Edison based its case upon the absolute absence of tangible intercorporate dealings, transactions and relations between itself and North American since 1935. In answering this argument the court said: "There is no showing that its [North American's] latent power to resume such control has been extinguished."7

In short, the decision is based upon two factors, viz., history, and the personal friendship and long association of certain Detroit Edison directors and officers with those of North American. The court's statement above must have referred to this intangible personal factor because, it must be remembered, United owns more of petitioner's stock than does North American.

This is the first case under sections 2 (a) (7)8 and 2 (a) (8) which has reached the courts. It indicates that the courts may allow the commission to interpret these sections even more broadly than they are written (and they are written very broadly). For instance, under clause (iii) of section 2 (a) (8) (B) the statutory phraseology is "are not subject to a controlling influence." This would seem to connote a present control presently exercised. The court, however, talks of "latent power to resume control," thus indicating that a present control is unnecessary. If Congress intended the interpretation invoked in the instant case it should have said "are not susceptible to becoming subject to a controlling influence," or are not "likely to become subject," etc. The court seems to have interpreted "subject to" control as meaning possibility of control. This interpretation carried to its logical conclusion reaches the epitome of absurdity. By this reasoning if North American had sold all of its Detroit Edison stock the holding company-subsidiary relationship might be continued so long as North American remained financially able to repurchase the stock. Obviously the court intended to base its decision on the ground that there was a likelihood of influence being exercised by North American, not that there was a mere possibility.

The last interpretation is indefinite enough. However, it affords a basis upon which lawyers may hazard an opinion in advising a client. The act requires the commission to lay great emphasis on intangible relationships and influence which may result in "control." In an inquiry as to the existence of such intangibles, clear and convincing proof is all but impossible to obtain and, in the normal case, will not be obtained. The commission faces the further difficulty that the actual facts are peculiarly within the knowledge of the applicant. So the

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8 Sec. 2 (a) (7) defines "holding company" but the tests and exceptions therein are identical with § 2 (a) (8). For the present purposes they may be considered as identical.
commission has adopted the rule of probabilities in construing the act. From the facts as stated in the instant case the result does not seem unreasonable, particularly when we remember that two Detroit Edison directors are also North American officers.  

As already stated, this is the only case under this provision of the act which has reached the courts. The administrative holdings are no great aid in construing the statute. However, it is possible to draw certain general conclusions from the holdings. For instance, where the utility’s stock is held in a voting trust and the trustees are officers, directors, or employees of holding companies, a “controlling influence” has been found to exist.  

When more than the statutory ten per cent of petitioner’s stock is held by one holding company but the lion’s share of petitioner’s stock is owned by a second holding company which exercises control, it has been found that the first holding company exercises no controlling influence within the meaning of the act. In the converse of this last situation (petition by a holding company that a “subsidiary” be declared not to be a subsidiary where petitioner owns more than ten per cent of the subsidiary’s stock but another company, or other companies, are in the driver’s seat by virtue of their larger holdings) a like result is reached. Where the holding company or operating company, as the case may be, has ceased to engage actively in business due to bankruptcy or the leasing of all its property, and has become a dormant corporate shell, it is held that an exception may be granted under sections 2 (a) (7) or (8). Perhaps these decisions rest on the ground that it is not “necessary or appropriate in the public interest or for the protection of investors or consumers” that the petitioner be subject to the liabilities and duties under the act. This is the ground for exempting the case of an American holding company with a foreign subsidiary from the provisions of the act.  

The court also emphasized Mr. Dow’s continued position of dominance in Detroit Edison’s affairs throughout its entire corporate existence. In view of the close association between North American and Mr. Dow in the formation of Detroit Edison, this would appear to be a fact very damaging to petitioner’s case. However, persons who are acquainted with Mr. Dow assure me that he is not a man to be “controlled” by anyone and that if any “influence” is exerted between Detroit Edison and North American, it moves from Mr. Dow to North American rather than in the other direction.  


Matter of Federal Light & Traction Co., 5 S. E. C. 140 (1939) (two cases).  


Secs. 2 (a) (7) (B), (iii) and 2 (a) (8) (B) (iii) of the act.  

Matter of Italian Superpower Corp., 1 S. E. C. 282 (1936). The subsidiary was partly owned and entirely controlled by the Kingdom of Italy.
In certain situations "controlling influence," having once existed, has been destroyed, as was attempted in the principal case. Thus where petitioner owned all the stock of two operating utilities but transferred the voting rights in connection with the lease of certain mines, petitioner was exempted under section 2 (a) (7) (B), and the operating utilities were declared not to be subsidiary companies. And where either the parent or subsidiary is in the process of reorganization which will result in the cancellation of the equities of the present stockholders, together with the "controlling influence" of the parent company, exemption from the provisions of the act has been granted. It has been held that an operating utility may be simultaneously the subsidiary of three different companies. In this case there was no express agreement or contract but officers of all three parents were also officers of the subsidiary. In another case where three companies owned an operating utility in about the same ratio but the subsidiary company was economically dependent upon one of the three, which bought ninety-five per cent of the subsidiary's output, it was held that the operating subsidiary was not a subsidiary of one of the other two companies.

In one case a company successfully accomplished what was attempted in the principal case. There the holding company liquidated its stock and systematically weeded out interlocking directors and officers until there was not even the suspicion of "controlling influence."

Before attempting to draw any conclusions from the above cases let us look at the same problem in connection with another phase of regulation attempted under the act.

2.

*Matter of Dayton Power & Light Company* 22

This proceeding arose under the old Rule U-12F-2 of the commission. In 1940 Dayton Power & Light proposed to issue $25,000,000 in refunding bonds. Morgan Stanley & Co. was selected to

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17 Matter of Cresson Electric Light Co., 1 S. E. C. 379 (1936). This order was so framed that it must be periodically renewed.
23 The rule, in substance, provided that no underwriter's fees should be paid to any person who stood in such relation to the person by whom the fee was to be paid "that there is liable to be or to have been an absence of arm's-length bargaining with respect to the transaction." Counsel for the Dayton and Morgan Stanley interests raised serious questions as to the validity of this rule. As these questions are immaterial to the present purpose, they will not be discussed.

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head the underwriting group. Dayton Power & Light applied to the commission for an exemption from the provisions of section 6 (a) of the act.\textsuperscript{24} The commission on its own motion issued an order to show cause why Rule U-r2F-2 did not bar the payment of underwriting fees.

At the subsequent hearing it developed that there was no evidence of any agreement, collusion, or intangible relationship between Morgan Stanley and Dayton.\textsuperscript{25} So, in denying the underwriting fees to Morgan Stanley, the commission relied upon a circle of past and present relationship, both intercorporate and personal, that is all but nebulous. Briefly summarized, the facts upon which the decision rested are these:

In 1928 J. P. Morgan & Co. caused the formation of The United Corporation, a public utility holding company. United owns 19.6 per cent of the stock of the Columbia Gas & Electric Corporation. Thus Columbia is a statutory subsidiary of United under section 2 (a) (8) (A) of the act. Columbia in turn owns one hundred per cent of Dayton. Due to the Federal Banking Act of 1933,\textsuperscript{26} it became impossible for J. P. Morgan & Co. to continue in the investment banking business. So in 1935, when investment banking again appeared to be profitable, certain Morgan partners resigned from J. P. Morgan & Co. and formed Morgan Stanley. Morgan Stanley's capital structure consisted of $7,000,000 of six per cent nonvoting preferred stock and $500,000 common stock. Immediately after Morgan Stanley's organization, individual J. P. Morgan partners held $6,600,000 of its preferred stock. At the time of the hearing this amount had been reduced to $3,580,000 or 35.8 per cent of Morgan Stanley's total capitalization. Morgan Stanley officers and directors hold securities representing 42.5 per cent of Morgan Stanley's capitalization. But it is essential to remember that all voting securities are held by Morgan Stanley's officers and directors.

These are the essential and underlying facts upon which the decision was based. From them the commission found that J. P. Morgan had a financial interest in the success of Morgan Stanley, that J. P. Morgan dictated to United, which dictated to Columbia, which dic-

\textsuperscript{24} Sec. 6 (a) of the act forbids the issuance of securities unless certain formalities provided for in § 7 have been taken with the approval of the commission as required by § 7. Under § 6 (b) an exemption may be granted from the prohibition contained in § 6 (a) when the funds realized from the sale of proposed securities are to be used solely for the purpose of financing the securities of the subsidiary company.

\textsuperscript{25} The writer has not seen the record of the proceedings. But the writer has had opportunity to examine the briefs submitted on behalf of Dayton and Morgan Stanley. Since these briefs were prepared by counsel of unimpeachable integrity, a reliance thereon seems justified. The statement instantly footnoted is substantiated by those briefs and is not contradicted in the report of the commission.

tated to Dayton. Therefore the commission found that there was likely to have been an absence of arm's length bargaining.

As pointed out in the briefs by Dayton's counsel, if one link in the above chain of relationship is broken, the whole chain falls. Let us examine each link briefly.

(a) **J. P. Morgan-Morgan Stanley Relations.** This seems to be the most substantial link of the chain and it is weak enough. Certain members of the Morgan firm have a personal financial interest in Morgan Stanley's business success because of their preferred holdings. Any actual influence exerted by J. P. Morgan upon Morgan Stanley must rest upon the intangible factor of former business associations between the officers of both firms because, it must be remembered, the Morgan Stanley stock which is held by J. P. Morgan officers is nonvoting.

(b) **J. P. Morgan-United Relations.** In its opinion the commission quotes Representative Rayburn as follows:

"... the banking houses control the holding companies which control the operating companies. One big banking house, through a company called 'United Corporation,' has an arrangement by which 8 or 10 of these big holding companies are tied together, so that more than one-fourth of the electric-light companies in the entire United States are subject to that banking influence."  

At one time this statement was probably reasonably accurate. J. P. Morgan & Co. did organize United in 1928. Immediately after its organization, J. P. Morgan & Co. held about one-third of United's stock. By 1929, however, this had been reduced to 3.5 per cent and its reduction was continued until in 1939 J. P. Morgan & Co. held less than one-half of one per cent of United's voting securities. At this time the St. Regis Paper Co. held 7.9 per cent of United's voting securities, American Superpower Corp. held 6.2 per cent, and Commercial Enterprises Corp. 1 per cent. In 1939 the Morgan holdings of United's preferred securities were negligible. Since March of 1938 no officer of J. P. Morgan or of Morgan Stanley has been officially connected with United Corporation. Mr. Whitney, a Morgan partner, served on United's board until 1938. He has been consulted by Mr. Howard, a United director, once since 1938, when Mr. Howard desired advice in connection with certain United affairs. At no time have J. P. Morgan partners ever constituted a majority of United's board.

(c) **United-Columbia and Dayton Relations.** The relations be-

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28 For the detailed history of United's organization, see 37 Col. L. Rev. 785, 936 (1937).
tween United and Columbia and between Columbia and Dayton may be tersely stated by saying that United owns 19.6 per cent of Columbia and Columbia owns one hundred per cent of Dayton. Formerly there were directors and officers of United who were also directors and officers of Columbia, but there have been no such intercorporate tie-ups since before Morgan Stanley was organized. At the hearing there was uncontradicted testimony to the effect that United never attempted to influence Columbia policies. Likewise there was uncontradicted evidence to the effect that Columbia did not interfere in the corporate affairs of Dayton, but due to the fact that Dayton is a one hundred per cent subsidiary of Columbia this point was not seriously relied upon.

The facts set forth above are not a detailed statement of all the facts shown, but they are the basic and fundamental facts upon which the commission rested its holding. They form a chain by which it was found that there was likely to have been an absence of arm’s length bargaining between Dayton and Morgan Stanley. It is significant to notice that in each link the control of the one corporation over the other must rest upon the fact that the officers of both corporations have been close friends, or have long done business with each other. In no link, with the single exception of that between Columbia and Dayton, did one corporation dominate the other financially, or by tangible methods. As to the control exercised over Columbia by United, the commission, after pointing out that under the act Columbia was a United subsidiary because United owned more than ten per cent of Columbia’s stock, said:

"By reason of the status of Dayton and Columbia as subsidiaries of United, therefore, it follows as a matter of course that a person influential in the financial affairs of United would also stand in a similar relationship to United’s subsidiaries. . . ."

This simply is not true. The fact that a subsidiary is such for purposes of the act does not connote that the parent dominates the subsidiary. The commission should be the first to concede this proposition, since it has itself declared one utility to be simultaneously the subsidiary of three companies and it is a long-established principle that "no man can serve two masters," much less serve three.

It is submitted that the commission based its decision not upon what was proved but upon what was suspected because of the past history of the corporations involved. It will be conceded that at one time J. P. Morgan & Co. did control United and that United exerted strong influence on Columbia. But from reading the facts as stated

by the commission, one concludes that these corporations had made an honest effort to remove that influence. The commission's finding that they failed indicates that, once such influence has existed, nothing short of the parent company's sale of the subsidiary's stock will serve to remove that influence, and that even then the commission may find that the influence continues.

The instant case is rendered more ridiculous by the fact that in this case it was proved that the parties actually did deal at "arm's length" and that Dayton drove a hard bargain. In mentioning the latter fact the commission said:

"... we recognize that the prices of 104 to the public and 102 ¾ to the company were not discernibly out of line with the prevailing market, and the spread of 1 ¾ for the underwriters was among the lowest of those taken on comparable public utility issues during the last five years. Of course most of these negotiations took place while the hearings in this proceeding were being conducted, and that circumstance must have affected the outcome." 81

Thus the commission found that there was likely to have been an absence of arm's-length bargaining despite the fact that there was no such absence. 82

The effect of the instant decision would seem to be that the utility and its underwriter must deal at arm's length, and take the chances that the commission will view the negotiations with suspicion.

3.

The question in the Dayton case was whether the negotiations with the underwriters were under such circumstances that there was likely to have been an absence of arms-length bargaining. In the last analysis this can only mean that the question was whether either the utility or the underwriter exerted a controlling influence over the other or whether some outside organization or person exerted a controlling influence over both. Thus we return again to the question which was raised at the beginning, namely, what is a controlling influence? One is tempted to answer glibly that a controlling influence is whatever the commission says it is, but such an answer, while reasonably accurate, is worthless.

82 The commission itself seems to have recognized some of the shortcomings of Rule U-12F-2, for that rule has been abolished and in its place has been substituted Rule U-50. The new rule requires competitive bidding for the underwriting of securities of public utility holding companies and their subsidiaries.
While the term as interpreted by the commission is indefinite, it is possible to make certain generalizations in regard to "controlling influence." Controlling influence exists where two corporations have interlocking directorates, even though the directors who serve on both boards are much less than a majority of either; it exists where one company is financially dependent upon the other. Where it has once existed it is almost presumed to exist unless it can be proven beyond the shadow of suspicion that it no longer exists. Past intercorporate relations are a factor to be considered in determining whether a controlling influence exists. The commission lays such weight upon past control (prior to the act) that they all but visit the sins of the fathers upon the children. The likelihood of the exercise of future influence is also a factor to be considered. Likewise the friendship and business confidence which the officers of the two corporations place in each other may result in a finding that a controlling influence exists. This seems to the writer to be particularly unreasonable.

In the opinion of the writer the term "controlling influence" has been consistently interpreted by the commission to mean "influence" only. Certainly the word "controlling" has not been given its ordinary significance. In making this interpretation the commission has sacrificed the desirable course of giving the act a literal interpretation and has exercised its discretion to foster what it believes to be the economic policy underlying the act. It is submitted that such a course is of questionable soundness.

Smith Warder

88 In their brief, counsel for Dayton Power & Light vigorously attacked this premise and the commission avoided a statement of this doctrine in so many words.