FEDERAL CONTROL OVER CORPORATE DISTRIBUTIONS TO
STOCKHOLDERS UNDER THE PUBLIC UTILITY
HOLDING COMPANY ACT

One of the major problems brought into vivid focus by the financial toll of the recent business depression has been the need for protecting the small stockholder or creditor of a large corporation from injudicious distributions of assets, which might threaten the safety of his investment. Such distributions, usually in the form of a dividend payment or of a stock reacquisition, have been, in general, regulated solely by state incorporation statutes.1 The results have been notoriously ineffective. Since 1933, sporadic legislative amendments have worked some slight improvements in state regulation. These improvements, however, are overshadowed by the Congressional experiment, embodied in the Public Utility Holding Company Act of 1935,2 at a thoroughgoing system of federal control over corporate distributions. It is true that the Holding Company Act affects only public utility holding companies engaged in interstate commerce, and their subsidiaries. But as proposals

1. Railroads are a notable exception. See note 41 infra.
for federal incorporation grow more insistent, the holding company field may well become a laboratory in which are nurtured the bases for regulation of the distribution policies of all American corporations engaged in interstate commerce. It therefore becomes of current importance to consider, in the light of the experience under state incorporation statutes, and of the practice under the Holding Company Act, the need for a comprehensive program of regulation, and the form such a program should assume.

The need for comprehensive regulation has grown increasingly acute with the growing complexity of corporate structure. The law governing corporate distributions emerged to meet the needs of a simple business community: the small corporation, actively controlled and managed by a few stockholders who were, typically, known to the creditors. Whatever protection against corporate distributions was necessary was, as in the case of an individual or partnership, for the benefit of creditors. The growth of giant enterprises, accompanied by the wide dispersion of stock ownership and the divorcement of ownership from control, has deprived the stockholder of his former power over corporate distributions. This power is now vested in a self-perpetuating management, with an interest of its own—in jobs, salaries, bonuses and executive power—which may be contrary to the best interest of stockholders. To preserve his interest, the manager must create an impression of success. To this end he may often resort to unsound accounting so as to report apparent earnings, and dissipations of needed corporation assets so as to pay regular dividends. The investor in his original security contract


4. See Berle and Means, The Modern Corporation and Private Property (1932) (hereinafter referred to as “Berle and Means”). It is there demonstrated that of the 200 largest non-banking corporations, controlling some 50% of the corporate wealth and almost 25% of the national wealth, 129, embracing 80% of the wealth of the 200, were controlled by an independent management or by a legal device; another 40, with 14% of the wealth of the 200, were managed by important minority stockholders, with the majority outside the pale of management. See especially pp. 18–118. Cf. Twentieth Century Fund, Big Business, Its Growth and Its Place (1937); Liggett v. Lee, 288 U.S. 517, 541 (1933), Justice Brandeis dissenting.


6. The word “investor” when used in this Comment includes both creditors and stockholders. The term “creditor” when used refers especially to bondholders and other
seldom adequately restricts this freedom of action in the manager to determine corporate distribution policies, since the contract is normally formulated by the management and the underwriter, and offered to the investor as a *fait accompli*. As a result, in appraising the need for protection from injudicious corporate distributions the stockholder's interest must be classified with that of the creditor.⁷

The preferred stockholder, if past practice is any guide,⁸ is even more likely than the creditor to be injured by dissipation of corporate assets through unwise distributions. Both creditor and preferred stockholder expect an ultimate refund of their principal, but neither has an effective voting interest to disapprove of distributions which may operate to defeat their expectation. The preferred stockholder's interest is, however, subordinate to, and hence more precarious than, the creditor's; his investment, moreover, is exposed to business fluctuations and the vicissitudes of corporate policy for a considerably longer period than the creditor's.

The common stockholder, who has theoretical voting control, and is the usual beneficiary of distributions, might seem to require no protection. Under absentee ownership, however, the common stockholder no longer possesses first-hand knowledge of corporate affairs. He may, as a result, treat as surplus earnings justifiably available for purposes of consumption, a distribution which is in fact a return of a portion of his original investment.⁹ Further, as has been demonstrated by the practical operation of the proxy system, the stockholder has been shorn of actual control.¹⁰ An unchecked management, therefore, by making an ill-advised distribution, even to preferred stockholders, may so endanger the financial soundness of the enterprise as to lead to insolvency. Since the impact of reorganization falls most heavily on the junior shareholders, the untimely payment may be a source of irreparable damage to them.

Attempts at statutory protection of investors were made early in the development of the corporate system. Almost without exception, state regulators for a period longer than one year inasmuch as the short term creditor is little affected by most of the practices discussed herein.

7. Though it might be argued that an independent management might be less disposed than a common stock management to make distributions at the expense of preferred stockholders or creditors, the managers, their self-interest aside, are often owners of common stock. *Berle and Means*, 95-118, analyzing the holdings of the management in the 200 largest corporations. And see SEC Report, Pt. VII (1938) 148-176, describing the common stock interest of the management attempting to promulgate recapitalization plans calling for sacrifices by the preferred stockholders.


9. Another instance of a direct injury would be that to the remainderman's interest in shares of stock when dividends out of capital were paid to the life estate.

lation stemmed from the famous decision, in 1824, of Wood v. Dummer, in which Mr. Justice Story outlawed a distribution of assets to stockholders on the ground that the "capital stock" was "a 'trust fund' for the payment of all the debts of a corporation"—a fund the preservation of which is relied upon by those extending credit to the corporation. The factual basis of the case and the much criticized doctrinal implications of the use of the term "trust" are of no present concern. But the basic idea expressed in the opinion—that the investment of the stockholder shall be retained intact in the enterprise as a margin of safety for creditors has now been codified in some form in the corporation laws of virtually every state. 

12. To the effect that the elements of a trust are lacking, see Hunt, The Trust Fund Theory and Some Substitutes For It (1902) 12 Yale L. J. 63. See also McDonald v. Williams, 174 U. S. 397 (1899), limiting the application of the trust fund doctrine to insolvent corporations, and Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 50 N. W. 1117 (1892), repudiating the doctrine to adopt a reliance rationale. For the persistence of the doctrine in the case law, see Comment (1938) 47 Yale L. J. 1164, n. 36, 51, 65.
13. The idea, as applied in subsequent decisions and statutes, will henceforth be referred to as the rule of Wood v. Dummer.
15. There has been a great confusion of terminology in the statutes and decisions attempting to apply the rule of Wood v. Dummer. A few fundamental distinctions of terminology are necessary for the discussion to follow. The assets upon which a corporation operates, generically described as "capital," are derived from two primary sources, its creditors and its stockholders. In the balance sheet of the company this source distinction is made on one side only, that showing liabilities and net worth. There is not, and of course cannot be, any such separation of the assets. In the most elementary manner the net-worth section may be described as made up of, first, the amount of the contribution made by the stockholders and dedicated to the business, this being the "Capital Stock" account, and, second, the so-called "Surplus" account which reflects the fortunes of the business and may, at any given time, show either a surplus or a deficit as the result of past operations. Since current legislation permits splitting up Capital Stock into various accounts at the discretion of the directors, and labeling one portion as Capital Surplus (if divided at the issue of the stock it is labeled Paid-in Surplus; if at a subsequent date, Reduction Surplus), it must be kept clearly in mind that the amount of the assets con-
The rule against impairment of capital, as thus expressed, gives a deceptive impression of strength and certainty; in practice it has proved vulnerable to widespread evasion. Charter-mongering states soon developed a thriving incorporation business by sanctioning or winking at methods to geld the rule. A few states—important ones—were bold enough to emasculate the rule on the face of the statute: dividends paid while capital was impaired were sanctioned so long as they were measured by current earnings. The distributed by the stockholders, the source of which is disclosed by the net worth section of the balance sheet, is actually the sum of Capital Stock and Capital Surplus (Paid-in plus Reduction Surplus). To distinguish the surplus arising from profits of the business from this misnamed Capital Surplus, those profits are described as Earned Surplus and are the only surplus available for distribution within the rule of _Wood v. Dummer_. See Callahan, _Statutory Protection of Creditors in Reduction of Capital Stock_ (1936) 2 Ohio St. L. J. 220. Cf. Ballantine and Hills, _Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws_ (1935) 23 Calif. L. Rev. 229, 231-238. The terms "paid out of capital," "dividends out of capital," and "impairment of capital" are used in this Comment with respect to distributions of assets which have the effect of reducing the amount of Capital Stock plus Capital Surplus on the balance sheet below the total thus set up to indicate the source of the assets contributed by the stockholders.

16. A consideration of the condition of the state incorporation law necessarily must be weighted by the number and size of corporations incorporated in the various states. Strangely enough, such figures do not appear to be available. Samples are here presented, however, embracing the large corporations which are the subject matter of this Comment. Poor's Industrial and Utility Volumes list 7000 corporations, supposedly with the largest public interest, by states of incorporation. These have been measured and estimated but not actually counted. The Federal Trade Commission listed the states of incorporation and the assets of 396 domestic corporations with assets of $50,000,000 and over. _Hearings on S. 10 and S. 3072, supra_ note 3, at 768. These compilations follow:

<table>
<thead>
<tr>
<th>State</th>
<th>Poor's No.</th>
<th>Poor's Assets (% of total)</th>
<th>F. T. C. No.</th>
<th>F. T. C. Assets (% of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>22%</td>
<td>26%</td>
<td>27%</td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>10%</td>
<td>16%</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Ohio</td>
<td>7%</td>
<td>5%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>6%</td>
<td>3%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>New Jersey</td>
<td>5%</td>
<td>10%</td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>4%</td>
<td>5%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td>4%</td>
<td>1%</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>California</td>
<td>4%</td>
<td>3%</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Maine</td>
<td>2%</td>
<td>3%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>2%</td>
<td>3%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>74%</strong></td>
<td><strong>83%</strong></td>
<td><strong>94%</strong></td>
<td></td>
</tr>
</tbody>
</table>

Thus, among the largest corporations, the corporation law of eleven states deserves the major emphasis. As the number of corporations included in the sample gets smaller and their size larger the proportion incorporated in the major states increases. Of the 573 corporations listed on the New York Stock Exchange in 1928, Delaware claimed 26%, New York 21%, and New Jersey 16%. _Berle and Means_, 204, n. 18.

17. Five states permit dividends out of current earnings despite a capital impairment. Three of these restrict this privilege entirely when a deficiency exists not only in the common capital but in the preferred as well. _Del. Rev. Code_ (1935) § 2066; Ga. Laws,
bulk of the states resorted to the more subtle method of devising schemes under which "capital stock" could be called "surplus." Most important was the sanctioning of a division of the consideration paid for no-par stock between capital stock and surplus, thereby creating a "paid-in" surplus free under state statutes for distribution as dividends.18 Those who lacked the foresight to employ no-par financing had scant difficulty in clearing the ground for distributions out of capital. By reducing the stated amount of the capital stock of the corporation and thereby creating a reduction surplus or eliminating a deficit the way was paved for present or future distributions. Less obviously, the reduction, by allowing a write-down of assets against a reduction surplus, diminished depreciation charged to income, and to that extent increased the income available for dividends. So long as the corporation was not rendered insolvent by the distribution10 following the reduction in capital, the managers did not run afoul of state statutes.20 Theirs was only the routine task of feeding proxies to dividend-hungry stockholders to induce an approval of the reduction. Corporate managers could circumvent the rule


19. Actually the distribution was limited so that assets could not be reduced below the sum of liabilities and capital stock, as reduced. Since, however, the capital stock could be reduced to a nominal amount, the restriction thus imposed was, in effect, limited to the insolvency situation.

20. On the state law on reduction of capital, see Comment (1935) 44 Yale L. J. 1025; Callahan, Statutory Protection of Creditors in Reduction of Capital Stock: (1939) 2 Ohio St. L. J. 220; SEC Report, Pt. VII (1938), 483-493; Maule, Capital Surplus and Corporate Net Worth (1936) 77-110.
against impairment in still another fashion by dressing up a distribution in the form of a purchase of the company's own stock. In the one-half of the states which imposed statutory limitations on the withdrawal of capital by the purchase of the corporation's own shares, resort could be had to the "paid-in" surplus and "reduction" surplus dodges. With these obvious methods of subterfuge available, rare indeed was the corporate manager who impaled himself on the rule against impairment. In fact, even when a manager was so unwary as to commit an impairment, creditors and stockholders had scant protection, for their preventive and compensatory remedies alike were woefully inadequate.

Since 1933 there have been some efforts to plug these gaps. By providing that a company's own shares may be purchased only out of earned surplus,

21. In the other half of the states, the common law rules are in conflict. On treasury stock, see generally Nussbaum, Acquisition By A Corporation of Its Own Stock (1935) 35 COL. L. REV. 971; Levy, Purchase By A Corporation of Its Own Stock (1930) 15 MINN. L. REV. 1; MARPLE, op. cit. supra note 20, at 53-76, analyzing the statutes. The English law prohibits purchase of treasury shares. Trevor v. Whitworth, 12 App. Cas. 409 (1887); PALMER'S COMPANY LAW (16th ed. 1938) 56-57.

22. It has been held that an injunction sought by a common stockholder will not lie against the declaration of a preferred dividend because the statute provides an adequate remedy at law. Schoenfeld v. American Can Co., 55 Atl. 1044 (N. J. Ch. 1903). Compensatory remedies against a stockholder recipient of an illegal dividend are meager. At common law, in the absence of knowledge he is not liable. McDonald v. Williams, 174 U. S. 397 (1899); Quintal v. Adler, 146 Misc. 300, 262 N. Y. Supp. 126 (1933), aff'd, 238 App. Div. 820, 262 N. Y. Supp. 924 (1933); rearg. denied, 239 App. Div. 775 (1933); aff'd, 264 N. Y. 452, 191 N. E. 509 (1934); Bartlett v. Smith, 162 Md. 478, 160 Atl. 440, 161 Atl. 509 (1932), collecting the authority contra. The statutes of a few states, however, give a remedy against the innocent stockholder. IDAHO CODE ANN. (1932) § 29-130 (where directors do not satisfy creditors); IOWA CODE (1935) § 8378; LA. GEN. STAT. ANN. (Dart, 1939) § 1107 (where directors do not satisfy creditors); ME. RV. STAT. (1930) c. 56, § 102; Md. Laws 1937, c. 504, § 9; MICH. STAT. ANN. (Henderson, 1937) § 21.48; MISS. CODE ANN. (1930) § 4149; R. I. GEN. LAWS (1938) c. 116, Art. II, § 38; VA. CODE ANN. (Michie & Sublett, 1936) § 3840; WASH. REV. STAT. ANN. (Remington, Supp. 1939) § 3803-25 (where directors do not satisfy creditors); W. VA. CODE ANN. (Michie & Sublett, 1937) § 3090; WIS. STAT. (1937) § 182.19. The creditor's remedy against the directors probably also lies only in event of dissolution or insolvency. Comment (1935) 44 YALE L. J. 1025, 1030, n. 16, analyzing the statutes. The plea by the director that he relied in good faith upon the financial statements furnished by responsible officers or accountants is expressly made a complete defense in eleven states, including Delaware, New York, Illinois and California, and probably would excuse him in virtually all the states. Dissenting directors are also excused. The stockholder, to bring an action, must surmount, in addition to the expense, the difficult procedural obstacles involved in joining the corporation and the directors as defendants, since most statutes grant the remedy against the directors to the corporation. But cf. Appleton v. American Malting Co., 65 N. J. Eq. 375, 54 Atl. 454 (1903); Siegman v. Electric Vehicle Co., 72 N. J. Eq. 403, 65 Atl. 910 (1907); Cartwright v. Albuquerque Hotel Co., 36 N. M. 189, 11 P. (2d) 261 (1932). Interesting to the preferred stockholder is the possibility that upon reduction of capital stock he might secure an appraisal and liquidation of his stock. In re Kinney, 279 N. Y. 423, 18 N. E. (2d) 645 (1939).
Some states have sought to curb evasion by reacquisition of stock. In the dividend field, efforts have been directed at stopping the widest breach—the creation and distribution of paid-in and reduction surplus. Thus in a handful of states the creation of paid-in surplus or reduction surplus upon the issue of no-par preferred stock has been prohibited, the practice now being restricted to no-par common stock. Other revisions have imposed prohibitions on the payment of common dividends out of already-created paid-in surplus. Payment of preferred dividends out of this type of surplus, however, is still unrestricted.

Even the most advanced type of state legislation, then, falls short of the standard laid down in *Wood v. Dumner*—that the investment of the stockholders shall be retained intact in the business for the benefit of creditors (and stockholders). The extent of the protection furnished by *Wood v. Dumner* itself, however, depends upon the tools employed to determine the adherence to the terms of the rule—that the assets contributed by the stockholders have been retained intact and that only earned surplus is being distributed. The most obvious set of equipment and the one initially to be employed in making the determination is sound accounting procedure. For the purposes of this Comment, the most significant accounting problems cluster about valuation of the fixed assets, which in the case of an operating company are its plant and equipment, and in the case of a holding company, its ownership of securities of subsidiaries. Sound accounting for fixed assets...


25. The statutes of California, Illinois, Michigan, Minnesota and Pennsylvania provide that dividends out of paid-in surplus shall be paid only to preferred shareholders, who shall be notified of the source. From the point of view of the preferred stockholder this restriction is more important than the restriction upon the creation of paid-in or reduction surplus from preferred stock inasmuch as under the latter restriction such surplus could be created from common stock and distributed to common stockholders. The statutes barring dividends to common stockholders from paid-in or reduction surplus presumably include such surplus arising from common stock. Unfortunately common stockholders are not protected from preferred dividends. Since California and Minnesota permit dividends out of current earnings (see note 17 *supra*) the effect of these progressive steps may be largely vitiated in those states.

26. Many accounting problems arise in connection with valuation of current assets, especially inventories. Since, however, current assets are more susceptible of accurate valuation than fixed assets, injuries to investors as a result of inaccurate valuations are less likely.
necessitates that in calculating the amount of earned surplus available for dividends the cost of those assets be prorated over their life-span and charged against income annually to take care of depreciation, and that the assets contributed by the stockholders be valued at original cost.\textsuperscript{27}

The theory justifying the valuation of assets at cost is that, when acquired through an arms-length bargaining process, the cost is equal to the real worth. The determination of the cost of the assets, however, is often a difficult accounting problem. In a situation where no arms-length transaction occurs, as in the instance of a deal between two companies of the same corporate family, the presumption in favor of the figure set by the management permits the directors to assign to the transferred property a book value substantially in excess of its real worth.\textsuperscript{28} This inflation of cost is motivated by a desire to achieve inter-company profits which will allow dividends by the seller from the resulting surplus. Even where the sale is based upon bona fide bargaining, if the property is exchanged for stock of the buyer, the cost assigned to the assets acquired depends upon the solution of the difficult problem of valuing the stock.\textsuperscript{29} The presumption is again in favor of the directors' valuation—generally enough in excess of the par or stated value of the stock to create on the buyer's books a substantial surplus, available for dividends under state laws. When the value assigned by the directors

\textsuperscript{27} Cf. Sanders, Hatfield and Moore, A Statement of Accounting Principles (1938) 58-64. The effect of charging depreciation to income and distributing only earnings after depreciation is to accumulate in the business a fund, equal, when a fixed asset has been wholly depreciated, to the original cost of the asset. If this fund is to be used automatically to replace such wholly-depreciated plant, the investor might advance serious theoretical objections of economic validity. Such a system forces the shareholders to reinvest their funds at the discretion of the management, even though the productivity of the capital may be lower than in some other enterprise. According to the economists if it does not pay, because of lower productivity of capital, to invest new capital in order to carry on the business, economic waste results when depreciation reserves are accumulated and used to buy renewals. Cf. Fowler, The Depreciation of Capital (1934) 107-113. Consequently, it would be entirely defensible to erect a system of distribution of assets which would permit payments equal to profits before providing for depreciation; indeed this principle is already applied in the so-called "wasting-asset" companies. Realistically, the import of this theory is diminished in non-wasting-asset companies by the rarity of a complete replacement of plant; replacement there is generally a gradual process.

This depreciation process is also subject to the criticism that the cost of replacement, except for the sheerest coincidence, is almost certain to vary from the cost of the original equipment. Leaving aside questions of technological changes in the nature of the desirable equipment, economists point out that the fluctuations in the purchasing power of the dollars available for replacement may, assuming that the purchasing value of the dollar has declined, result in an insufficient fund for the reproduction of assets. Or, if the business is to be liquidated at the time the assets are worn out, the investor may find that the dollars he received, while equal in amount to the dollars he invested, do not have the same purchasing power as the original dollar. \textit{Id.} at 5.

\textsuperscript{28} The cases are collected in Berle and Means, 252-254, especially n. 10.

\textsuperscript{29} Sanders, Hatfield and Moore, \textit{op. cit. supra} note 27, at 59-60.

\textsuperscript{30} See note 28 \textit{supra}.
thus exceeds the real worth, the question is squarely presented whether the investor has relied upon the value assigned and the company should therefore be forbidden to make payments from earned surplus until the actual value of original assets plus subsequently earned assets equals the value assigned. Such a restriction on earned surplus might be considered fair on the assumption that the investor has relied on the larger figure faultily stated by the management and has no adequate means to ascertain the true value. On the other hand, such an assumption perhaps imposes too severe a penalty for faulty bookkeeping where the directors may have made an honest mistake in solving an intrinsically difficult valuation problem, and the actual value may furnish an adequate protective cushion to investors.31

Whichever figure is to be relied upon by the investor—that stated by the management or that representing the true value of the contributed assets—the scope of accounting techniques seriously limits their utility as tools to ascertain its retention in the business undiminished. Accountants do not attempt, except perhaps in dealing with current assets, to do more than record historical cost,32 from which current values fluctuate widely. Consequently, although the accountant’s historical figures might indicate that the capital cushion remains unimpaired, the apparent safety of the investor indicated by these figures may prove illusory if the current market value has dropped in the interim. The rule of Wood v. Dunncr must therefore be supplemented by indicia of value beyond those furnished by the historical costs presented by the accountant.33

No business problem is more difficult and uncertain of solution than that of valuation of the assets of an enterprise. The key to the solution, financial experts agree, is in the earning power of the assets. Capitalization of the earnings, at least in theory, will reveal the value of the assets.34 But what earnings to capitalize, and at what rate, are often practical problems of


32. Sanders, Hatfield and Moore, op. cit. supra note 27, at 59-60.


34. See Dewing, Financial Policy of Corporations (3d ed. 1934) 144.
extreme difficulty. The help given by the accountant’s income statement, recording past earnings, is limited to the extent that the present value is a function not so much of recorded past earnings as of estimated future earnings, subject to the action of such unpredictable factors as changes in technology, fickleness of consumer demand, additional competition and unfavorable legislation. The solution of this valuation problem, however difficult, is essential to an effective application of the rule of *Wood v. Dummer.*

The rule itself, however, whether coupled with the accountant’s historical figures or more current indicia of value, has one important shortcoming from the point of view of the investor whose principal may be threatened by withdrawals of capital. It assumes that an investor is adequately protected when the capital cushion on which he relied is preserved intact in the business. But when that capital contribution of the stockholders is small in relation to the contribution of the creditors, the thin cushion creates the ever-present danger that the reorganization provisions of the bankruptcy statutes may be touched off, either when a dwindling in the value of the fixed assets reduces the value of the total assets below liabilities so as to create insolvency in the bankruptcy sense, or when inadequate earnings or unforeseen operating reverses, coupled with the continual drain of the liquid assets of the company to meet the interest due on the bonds, forces a default on the bonds, creating insolvency in the equity sense. Apart from the social waste consequent upon bankruptcy, under existing reorganization standards the full loss may well be visited on junior stockholders. The rule of *Wood v. Dummer,* in safeguarding the capital cushion, is thus adequate to protect the investor, especially the stockholder, only when the cushion itself is sufficient to remove

35. For a full discussion of the technique of capitalization of earnings, see id. at 144 et seq.

36. Chapter X of the Chandler Act treats insolvency in either the bankruptcy or the equity sense as a basis for reorganization. 52 Stat. 886, 11 U. S. C. A. § 530 (Supp. 1938). To the effect that overcapitalization is an important cause of business failure, see Dewing, *op. cit. supra* note 34, at 1094-99; Jeremiah, *Corporate Bond Default* (1936) esp. 84; Fitzpatrick, *Symptoms of Industrial Failures* (1931) 124. The drain of liquid assets might also create insolvency in the bankruptcy sense—a more remote possibility.

37. The economists would have it that it pays socially for business enterprises to continue to operate so long as their revenues cover out-of-pocket costs, or their out-of-pocket losses are less than the losses which would be incurred by shutting down. Inability to pay interest, consequently, is not a useful criterion for determining when the enterprise should be subjected to the expense of insolvency proceedings. Harrod, *The Expansion of Credit in an Advancing Community* (1934) 1 Economica (n. s.) 287, 289 et seq.; Rostow and Cutler, *Completing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act* (1939) 48 Yale L. J. 1334, 1374; Frank, *Save America First* (1938) 385. To the effect that top-heavy debt structures may be an aggravating cause in depressions, see *Twentieth Century Fund, Debts and Recovery, 1929 to 1937* (1938) 176-217, 253.

the threat of reorganization. And the small investor is not only incompetent to appraise this risk, but also, in view of his inferior bargaining relation to the modern large corporation, is unable to secure an adequate capital cushion.

A modern system of control over distributions of corporate assets to stockholders might well be designed, therefore, to achieve for the investor the adequate capital cushion he is powerless to secure. Such a system would permit new issues of fixed obligations only when they did not furnish such a large proportion of the assets contributed by all investors as to create a danger that the continuity of the business would be interrupted by the intrusion of reorganization proceedings. Where, moreover, bonded debt disproportionate to assets already exists, the availability of earned surplus might well be restricted until a protective cushion has been built up, sufficient to remove the danger of reorganization.

The proportion of bonded indebtedness that a company can with safety carry depends both upon the margin of safety which must be present to insure that dwindling of the value of the assets will not lead to reorganization, and upon the sufficiency and stability of the earnings which produce the constant influx of liquid assets necessary to offset the continual drainage of assets required to pay bond interest and so stave off equity insolvency. Income statements over a long enough time-span provide a fairly reliable indication of the amount and stability of earnings. The related problem of whether the excess of assets over debts provides a sufficient margin, however, cannot be solved by using balance sheet figures to value the assets. Indicia of value beyond those revealed by historical accounting costs are here necessary, just as they were to determine whether the capital cushion remained intact as required by the rule of *Wood v. Dummer*. The technique there employed, capitalization of earnings, is again indicated.

Any modern system of control over distributions to stockholders, seeking to attain balanced financial structures by placing limits on new bond issues, or by limiting withdrawals from unbalanced structures until earned assets restore equilibrium, must attempt the solution of the difficult problem of valuation by capitalization of earnings. It must bring to bear, in the attempt, every tool at its command. Accounting tools, despite their limitations, may be of real assistance. The accountant's report of past earnings is a valuable clue to the trend of the future earnings which must be employed in asset valuation. A high debt-asset ratio calculated from the accountant's balance sheet, and instability of earnings revealed by his earnings report, may furnish the first indications of danger of an unbalanced financial structure. To insure prompt perception of the danger signals, it is justifiable to require retro-

39. See Moore, *Railroad Fixed Charges in Bankruptcy Proceedings* (1939) 47 J. Pol. Econ. 100, 107-115; Rostow and Cutler, *op. cit. supra* note 37, at 1375. Both articles suggest that when a "new" corporation emerges from the reorganization process this danger inherent in debt financing should be minimized.
spective correction of excessive valuations originally placed on assets by the management.

Accounting techniques thus furnish a valuable start in any realistic attack on the difficult problem of valuation which must be solved before unbalanced corporate structures can be eliminated. And it is this elimination of unbalanced corporate structures, rather than merely the preservation of the original capital cushion, at which the experiment in federal administrative control over distribution of corporate assets, recently undertaken by the Securities and Exchange Commission 40 under the Public Utility Holding Company Act of 1935, is directed.41

THE PUBLIC UTILITY HOLDING COMPANY ACT

The jurisdiction of the Securities and Exchange Commission over distribution of a corporation's assets rests directly on Section 12(c) of the Act which provides that:

"It shall be unlawful for any registered holding company or any subsidiary company thereof . . . to declare or pay any dividend on any security of such company or to acquire, retire, or redeem any security of such company, in contravention of 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."42

40. Hereinafter sometimes referred to as the "Commission" and sometimes as "SEC."

41. The Interstate Commerce Act, 41 Stat. 494 (1920), 49 U. S. C. § 20a (1934), gives the Interstate Commerce Commission jurisdiction over railroad financial practices. Thus § 20a (2) regulates the issue of capital stock or bonds and § 20a (12) makes it unlawful for any officer or director of a carrier to "participate in the making or paying of any dividend of an operating carrier from any funds properly included in the capital account." Violation of § 20a (12) is a misdemeanor punishable by fine, imprisonment or both. The constitutionality of § 20a (2) has been upheld. Pittsburgh & W. V. Ry. v. Interstate Commerce Comm., 293 Fed. 1001 (1923), appeal dismissed, 266 U. S. 640 (1924).

The statutory standard granted under § 20a (12) amounts to the equivalent of the rule against impairment. The case law on cash dividends, if any, is sparse, but questions of issue of stock dividends and dividends payable in bonds have arisen. The Commission has held that the issue of bonds as a dividend is not compatible with the public interest. Stock of Chicago, Burlington & Quincy R. R., 67 I. C. C. 156 (1921), N. Y. L. & W. Stock and Bonds, 131 I. C. C. 34 (1927). But cf. Charleston & Western C. Ry. Co. Bonds, 193 I. C. C. 309 (1933). Stock dividends have been permitted, Stock of Delaware, L. & W. R. R., 67 I. C. C. 426 (1921), although the Commission there said that "a substantial surplus should remain uncapitalized as a support for the applicant's credit . . . ." For a full discussion see SHARPFMAN, III—A THE INTERSTATE COMMERCE COMMISSION (1935) 502 et seq.

The words of this section of the statute appear clearly to provide the basis for full and effective protection of creditors and stockholders. Not only does Congress furnish the Commission with a standard amounting to a rule against impairment in the clause "to prevent the payment of dividends out of capital or unearned surplus," but it would appear that Congress, by the phrases "to protect the financial integrity of companies" and "to safeguard the working capital," intended to empower the Commission to protect investors from injuries which might result from withdrawals tending to render a corporate financial structure unbalanced or illiquid. Although it seems reasonable that this section might also be utilized to control the "reduction of capital stock" antics of utility corporations, the Commission has professed to find its sanction for such jurisdiction in Section 6(a)(2) which makes it unlawful for a registered holding company to "exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security" without an effective declaration under Section 7. And under Section 7(e) such a declaration is not to become effective if the Commission finds that the transaction will "result in an unfair or inequitable distribution of voting power or is otherwise detrimental to the public interest or the interest of investors or consumers." Section 7(f) further authorizes the Commission to impose such terms and conditions as it finds necessary to insure compliance with the section.

The Commission secures a further control over the financial structure of utility corporations by the terms of Section 6(a)(1) which requires an effective declaration before a registered company is able to issue or sell any security of such company. By the terms of Section 7(d), the declaration may be denied effectiveness if the security is not reasonably adapted to the earning power, or if the terms and conditions of the issue or sale are detrimental to the public interest or the interest of investors or consumers. Section 7(f) permits the imposition of terms as a condition of granting of the declaration.

43. Since the Commission has interpreted its power under §12(c) to extend to dividends out of earned surplus [see p. 506 infra], even if dividends were declared out of earnings subsequent to reduction the Commission, under its own conception of the scope of §12(c) could intervene at any time. Moreover, it could take the logical position that until earnings had been accumulated equal to the amount of the reduction of the capital, the dividends were actually out of capital surplus within the literal meaning of §12(c).


47. Section 6(b) permits the Commission to exempt from the provisions of subsection (a) the issue or sale of any security by any subsidiary company of a registered holding company, under certain circumstances, subject, however, to such terms and conditions as the Commission deems appropriate in the public interest or for the protection of investors or consumers. The control over financial structures exercised under §6(a)(1), therefore, may be exercised as well in connection with exemptions under §6(b).
With such grants of power at its disposal, as well as others of less present significance, the Commission appears equipped to execute a program measuring up to all the standards of investor protection suggested previously in this Comment. Not only could affirmative steps be taken under Section 12(c) and Sections 6(a)(2), 7(e) and 7(f) to restrict withdrawals even out of earned surplus until a more balanced financial structure is built up, but direct adjustments of the balance of the structures can be secured by vigilant enforcement of Sections 6(a)(1) and 7(d) and (f).

The opinions of the Commission indicate that it fully realizes the power it possesses. Considering the scope of Section 12(c), the Commission has stated that the section "makes unlawful the declaration or payment of any dividends in contravention not only of rules and regulations of the Commission, but also of its orders. . . . It is conceivable that under certain circumstances the Commission might prohibit the payment of dividends out of earned surplus by order, provided that the prescribed statutory standards existed." Furthermore, in extending Section 6(a)(2) to embrace "reduction" cases, the Commission has adopted a criterion perhaps even wider than Section 12(c); for under Section 7(e), complementary to Section 6(a)-(2), the Commission is to consider, and has actually considered, the purpose of the reduction not only in terms of inequitable distribution of voting power but also in terms of detriment to the public interest or the interest of investors or consumers.

If the Commission's conception of the broad scope of its power under Section 12(c) should turn out to be ill-grounded, the conditions attached by the Commission to Section 6(a) declarations will assume a vital importance.

48. An important power at the disposal of the Commission, which it has thus far utilized mostly as a threat, is its power under §11(b)(2) to take steps to distribute voting power fairly and equitably among security holders.

49. The Commission has promulgated three rules under §12(c). Rule U-12C-1, C. C. H. Secur. Act. Serv. §8400 (1937), covers the acquisition of a corporation's own securities and except for certain specified purposes and a leeway of 1/10 of 1% of the assets, requires an application to the Commission. Rule U-12C-2, id. at §8400A, requires that no declaration of dividends out of capital or unearned surplus may be made without the approval of the Commission. Rule U-12C-3, id. at §8400B, extends the scope of Rule U-12C-2 to cover payments of principal or interest on obligations issued as dividends out of capital or unearned surplus, whether such dividend was declared before or after the Act took effect. Because of its retroactive operation, this rule may create some constitutional difficulties. The Commission's jurisdiction, however, is not limited by its rules since the statute makes unlawful declaration or payment in contravention of orders as well. Since, however, the Commission has no procedure geared to secure notice of these dividends except through the usual financial channels, the dividend declarations it passes upon are only those under Rules U-12C-2 and U-12C-3 applications. Until further machinery is set up, the Commission may overlook undesirable payments not within the scope of existing rules. See note 53 infra.


for investor protection. Of course, if the power under 12(c) is plenary, these conditions may be, as one commissioner has argued, mere supererogations. None the less, the imposition of conditions under Section 6(a) serves to indicate the attitude the Commission will take under Section 12(c), if the companies under surveillance attempt to declare or pay dividends. In surveying the contributions made by the Commission in conducting this experiment in administrative control of corporate distribution policies, then, consideration must be given not only to decisions upon applications to pay dividends under Section 12(c), but also to cases in which the Commission has imposed conditions upon corporations coming within its jurisdiction under 6(a) (1) and 6(a) (2).

The Commission's opinions vividly indicate the impact of a realistic approach, in terms of liquidity, sufficiency of common stock equity and functional valuation of assets upon the problem of investor protection. In the cases arising under Section 6(a) (1), the conditions imposed by the Commission have varied with the type of security proposed. In applications for an issue of preferred stock for refunding purposes, the Commission has several times conditioned its acquiescence upon an agreement by the applicant not to purchase or otherwise acquire any of its common stock or pay any dividends or make other distributions on common which would impair the existing common capitalization. Except that corresponding limitations are not placed upon distributions to preferred stock, the Commission, by freezing the capital cushion, employs in these cases the rule of Wood v. Dunner.

The conclusion should not be drawn, however, that the Commission has adopted, in the preferred refunding cases, a restriction no stronger than the simple rule against impairment. That rule does not protect the senior investor against the dilution, by the issue of additional senior or coordinate securities, of the amount of assets per share behind his stock. By insisting in these cases on a limitation upon the issue of debentures or additional preferred, the Commission has provided preferred stockholders with a safeguard as essential for their protection as are limitations upon distributions of assets


53. One reason why the Commission may be imposing conditions under §6 (a) is the greater administrative feasibility of indicating what its policy is likely to be at the time the company's financial situation is under scrutiny rather than awaiting dividend declarations and studying each situation de novo. At the present time, moreover, the Commission has no procedure geared to secure notice of these dividends except through the usual financial channels. Presumably, however, the Commission would not feel bound to limit its jurisdiction under §12 (c) to the extent of restrictions imposed under §6a if it felt that changed conditions warranted more extensive limitations upon the corporation.

to junior stockholders. Provision was also made in these cases for passing the voting control to the preferred stockholders when dividend arrearages begin to accumulate—a measure of theoretical value, whose pragmatic importance may be questioned in view of the inadequacies of the proxy machinery as a device to consummate stockholder control.

A particularly striking departure from the *Wood v. Duntmer* rule appears in the *North American* case. There debenture bonds and preferred stock were to be issued, partly to refund existing obligations and partly to retire the debentures and preferred stock of a subsidiary about to be merged into the parent. Apparently based upon "informal suggestions" of the Commission, the declarant provided for the *preferred* shareholders protection of a character substantially in advance of the usual corporate practice. Thus dividends to common shareholders were contingent upon the existence of a cushion carved out of earned surplus in an amount equal to 15% of the aggregate par value of the preferred stock then outstanding. When this is added to the cushion furnished by the par values of the preferred and common stock, which par values could not be reduced without the future approval of the Commission, the total protection afforded preferred shareholders amounted to about 250% of the par value of the preferred shares. So far as distributions to common stockholders were concerned, the additional 15% limitation upon the distribution of earned surplus was in excess of any requirement under a rule against impairment. Added significance is assumed by this restriction when it is considered that the strong earning power of the applicant indicated that the real value of the assets perhaps exceeded the book value in terms of which the protection was couched. Furthermore, the depreciation and maintenance provisions of the declarant were most liberal, tending toward conservative earnings reports and conservative property values on the corporation's books. Thus the Commission has made a bargain for the investors far in excess of any which could be implied from state statutes, charters or by-laws.

The willingness of the Commission to make such bargains is also evident where the declarant has attempted to refund bonds. Here, too, the Commission, in certain instances, has moved far in advance of the traditional scope of the rule against impairment. In two cases where the debt-asset ratio

---

55. *See* cases cited *supra* note 54, especially *Central Ohio Light & Power Co.* case.
56. *See* note 55 *supra*.
59. Or an existing Reserve for Revaluation, which Reserve, however, was not to be augmented except by transfers from Earned Surplus.
60. The Commission also reserved jurisdiction over charges to the Reserve for Contingencies to exclude charges more properly made to Earned Surplus. In addition, preferred stockholders were given voting rights in default, based again on the Commission's "informal suggestions."
was a high one, the Commission reserved jurisdiction over common and preferred dividends in one instance, and over common in another, presumably even though earned surplus was available. In the latter of the two cases the Commission said:

"The extremely unsatisfactory ratio of debt to property indicates that the need for increasing the common stock equity of the applicant is very real. The order granting exemption will therefore contain the condition that no dividend upon the common stock of applicant shall be declared or paid except with the approval of this Commission."

In the same case, by way of dictum, the Commission said that it would decline, if the application were made, to permit the applicant to sell other bonds then in the treasury.

The standards thus set, in the bond refunding cases, for the restrictions on dividends are on a much higher level than those which freeze only the original capital investment, even though that capital investment be entirely inadequate. Effective administration of the "debt-asset ratio" criterion, however, calls for a realistic valuation of the assets, rather than an historical valuation based on some accounting measure such as cost of acquisition or cost when first dedicated to the public use. The Commission was confronted with just such a problem in the important Public Service of Colorado case. There the elimination of the intercompany profit from the asset accounts revealed that each $1 of original cost of assets supported $1.01 of debt. Such a situation, however, did not automatically warrant an absolute prohibition of dividends or an absolute refusal to permit the issue of the bonds. In this instance, the corporation had demonstrated its ability not only to meet its bond interest and preferred stock dividend requirements regularly but had continued to pay substantial annual common dividends out of earnings. Recognizing that the actual value of the assets was more nearly a capitalization of the company's earning power than a function of historical

---

61. Republic Service Corp., 2 S. E. C. 44 (1937). The Commission did not reveal how high the ratio was.

62. Virginia Public Service Co., Holding Company Act Release No. 1295, Oct. 23, 1938. The debt-asset ratio, after eliminating write-ups, was 86.8%.

63. Id. at 10.

64. In a few instances, the Commission has restricted dividends to future earnings. Sioux City Gas & Electric Co., 1 S. E. C. 570 (1936) (debt-asset ratio 80%; fixed charges covered 1.70 times and fixed charges and preferred stock dividends 1.04 times); Iowa Public Service Co., 2 S. E. C. 447 (1937); Central Illinois Electric and Gas Co., Holding Company Act Release No. 1592, June 19, 1939 (debt-asset ratio 107.8%; fixed charges covered 2.10 times). Provision has also been made in these cases for adequate depreciation and maintenance charges.


66. During the course of intercompany transactions, the parent acquired all the capital stock at no cost. Indeed, the parent profited in the process by some $1,300,000.
accounting cost, the Commission imposed dividend restrictions substantially less than would have been imposed by the rule against impairment. Although the elimination of the “water” in the assets revealed a book impairment of over $20,000,000, the company was permitted to pay dividends conditioned only upon a slow freezing of $7,800,000 into the capital cushion. This amount was to be provided by immediate conversion into common stock of a current account of $2,200,000 owed the parent, the freezing of an existing book surplus of $600,000 and the reservation from earnings of $500,000 each year for ten years. Had the rule against impairment been applied, the dividends of this company might have been entirely restricted until the difference between real and book value of the assets had been eliminated, while the dividends in the aforementioned two cases might have gone scot-free — results unjustified from the standpoint of realistic valuation.

The cases under Section 6(a) (2), involving reductions of capital stock, likewise illuminate the flexible levels of restriction which the Commission has imposed. In the Green Mountain case, the Commission resorted to the most restrictive of any of the conditions imposed in the reduction cases. There, when the declarant sought to reduce its capital stock to permit a write-down of fixed assets, thus paving the way for a refunding program,

---

67. The Commission has said that “for purposes of reorganization as distinguished from ‘value for rate-making purposes’ earning power becomes in the final analysis a paramount criterion [of the worth of a company’s assets],” Genessee Valley Gas Co., Inc., 3 S. E. C. 104, 112 (1938); and that “for reorganization purposes earning power rather than the book value of assets is the best test of value,” Community Power & Light Co., Holding Company Act Release No. 1803, Nov. 18, 1939, p. 10. The object of valuation for reorganization purposes is much the same as it is for investor protection from distributions—to determine the amount of assets available to the various classes of investors. In public utility cases, however, because of the complications of rate-making, “the earning power must be read with special connotations derived from the fact that rates ... will be subject to control by public authorities.” Commissioner Eicher, concurring in the Public Service of Colorado case, at 45. Cf. Central Illinois Electric & Gas Co., Holding Company Act Release No. 1592, June 19, 1939, Commissioners Healy, Eicher and Frank concurring at 13, 18, and 19 respectively.

68. Assuming that the Commission does not subsequently take a different stand under § 12 (c).

69. See note 31 supra.

70. Commissioner Healy, dissenting at 47, felt the SEC was bound by the historical cost figures which indicated a debt-asset ratio of over 100%. “Section 7 (d) (1) does not necessarily embody a prudent investment or original cost standard, but I do believe that it includes the standard of ‘actual investment.’ Actual investment excludes self-serving declarations of value and arbitrary appraisals. Actual investment is a matter of history, not of speculation”—p. 62.

71. Green Mountain Power Corp., Holding Company Act Release No. 1345, Dec. 6, 1938. In New York & Richmond Gas Co., Holding Company Act Release No. 1442, Feb. 16, 1939, the Commissioner prohibited the payment of any dividends without application under § 12 (c) (2). There, however, the reduction had not cleared away the uncertainties surrounding the property account. It is not believed this case goes as far as the Green Mountain case.
the declaration was approved subject to the provision that no distribution be made until accumulated earned surplus or new common capital exceed the amount of the reduction.72 The real need for protection in the Green Mountain case was emphasized by the comparative financial weakness of the company, as indicated by existing arrearages on the preferred stock, a slender margin of earnings available over the dividend requirements of the preferred shares, and a meager surplus account. In cases where the earnings available for the preferred were much more substantial, the Commission has imposed no such limitations upon dividends, but has contented itself with supervision of the charges made against the reduction surplus account to insure against diversion to that account of amounts more properly to be charged to earned surplus.73 In between these two poles is the important Columbia Gas case involving a reduction of capital stock.74 The significance of this case, however, can be understood only after considering the Commission's ruling upon prior applications by the company for permission to pay preferred and common stock dividends out of capital surplus.

In passing upon the company's dividend applications, the Commission had been greatly influenced by the consideration that the elimination of substantial intercompany write-ups of assets would greatly impair—to the extent, as subsequently developed, of at least $60,000,000—the stated capital. Since there existed, in addition to this impairment, pending extraordinary litigation, substantial liquidating values of the preferred stock in excess of the par values,75 a consistent draining of surplus and an unsettled general

72. Although, from the viewpoint of the preferred stockholder the cushion behind him was in accord with the rule of Wood v. Dummer, insofar as the replenishment of the amount of reduction by the infusion of new common capital allowed the declarant to pay dividends on new and old common stock before restoration of old capital, the protection afforded the old common stockholders was not equal to the standard of the rule against impairment.

73. Cincinnati Gas & Electric Co., Holding Company Act Release No. 1243, Sept. 15, 1938; United Fuel Gas Co., Holding Company Act Release No. 1360, Dec. 9, 1938; Ohio Fuel Gas Co., Holding Company Act Release No. 1720, Aug. 30, 1939. In the Cincinnati Gas case, the applicant earned its preferred dividends more than twice, despite a liberal maintenance and reserve policy, whereas in the Green Mountain case, the preferred dividend coverage over a period of eight years averaged about 1.25. In a few instances the Commission has approved the reduction without condition, although the basis of the decision is not clear from the opinions. San Antonio Public Service Co., 2 S. E. C. 366 (1937); American Public Service Co., 2 S. E. C. 47 (1937).

74. Holding Company Act Release No. 1417, Jan. 25, 1939. This case should be distinguished from the series of applications made by the same company for permission to pay dividends out of capital surplus, and reported under Release Nos. 1055 [3 S. E. C. 313 (1938)] 1152, 1265, and 1413.

75. The Commission has taken the justifiable position that it should consider the liquidating preferences of the preferred stock as well as the par value in determining the availability of surplus for dividends. Cf. SEC Accounting Release No. 9, Dec. 23, 1938, 135 C. C. H. Stock Exch. Reg. Serv., ¶8601.
business situation, the Commission’s prohibition of common stock dividends may have been warranted. The Commission, however, in view of a previously uninterrupted preferred dividend record, did not prohibit preferred dividends, but conditioned their payment upon a restoration of surplus out of the first subsequent earnings.

Confronted with the prohibition of common dividends resulting from impairment of capital stock, Columbia applied to the Commission for leave to reduce the stated value of its capital stock to create a reduction surplus against which to charge the overvaluation in the assets. The Commission, because it has taken the unnecessary view that if it consents to a reduction, dividends out of subsequent earnings are freed from its jurisdiction, was forced to give careful consideration to the conditions which it ought to impose to protect preferred stockholders and creditors. It seems obvious that the reduction in the stated capital should not reduce the protection accorded for, regardless of accounting manipulations, there is still an intrinsic impairment of capital. Yet the Commission partially removed the bars with which it had previously surrounded common dividends, by allowing their payment if sufficient surplus accumulated out of earnings subsequent to the reduction remained thereafter to equal preferred dividend requirements for a year and a half. The SEC then directed that the reduction be put to a class vote of the preferred stock. Thus, in the face of a potential impairment of capital of at least $60,000,000 the Commission permitted preferred and common dividends out of future earnings, contingent only upon the condition that common dividends be subject to an accumulation, for the protection of the preferred shareholders, of a year and a half’s preferred dividends, about $10,000,000; and the meaningless formality of a favorable vote of preferred shareholders.

The conclusion which the Commission reached in the series of Columbia Gas cases was reached in the face of the Congressional prohibition, in Section 12(c), of dividends out of capital or unearned surplus, which the Commission has interpreted to create “a strong presumption against the propriety of payment of dividends when capital is impaired.” In the other three important dividend cases before it—the United Corporation, Securities General and International Utilities cases—the Commission also overcame the presumption, and sanctioned dividends on preferred stock despite, in the United Corporation case, impairment of capital surplus, and in the other

76. See note 43 supra.
two cases, substantial impairments of the junior equity. In the last two cases, the Commission was influenced by the liquidity of the companies and the presence of an adequate protective cushion behind the preferred stock.

These cases suggest that there are circumstances in which it would be permissible to pay dividends out of other than earned surplus. One of these instances is presented by the Columbia Gas situation. There the alleged "impairment" was created at the organization of the company by accounting manipulations which placed the assets on the books at values higher than warranted by conservative accounting practice. Since, however, the actual assets had not been dissipated and the earnings available for dividends substantially exceeded preferred requirements, the Commission was justified in permitting the company to correct its balance sheet without paying a penalty for faulty bookkeeping. A second legitimate occasion for distribution out of other than earned surplus would seem to be presented where a corporation finds itself with a substantial amount of extra assets not needed in the business, as for example in the instance of a "wasting-asset" concern. If a careful survey of the remaining assets indicates a substantial protection to senior investors, the Commission should not stand in the way of such distribution. The United Corporation case may be placed in this category.

81. Pending before the Commission are two important cases under Section 12 (c). One of them may provide a test of the validity of Rule U-12C-3, supra note 49. Associated Gas and Electric Corporation, Holding Company Act Releases 1795, 1800, 1801, 1811. The other case is Metropolitan Edison Co., Holding Company Act Release 1817, Dec. 1, 1939. The Associated Gas case and the Metropolitan Edison case represent the first instances where the Commission has itself instituted the proceedings.


83. The cushion in the Securities General case amounted to 79% of the liquidating value of the preferred stock; in the International Utilities case to 145%; and 210% on the first and second preferred issues, respectively. In the North American case, the commission provided for a cushion of 150% behind the preferred stock.

84. In Columbia Gas & Electric Corp., 3 S. E. C. 313 (1938) the Commission said dividends had been paid in excess of earnings during the years 1936 and 1937. However, the Company had earned since organization some $202,000,000 and had paid out in cash only $175,000,000. Stock dividends, not constituting a distribution of assets, amounted to $61,000,000.

85. The state statutes generally permit the return of capital currently out of depletion. Del. Rev. Code (1935) § 2066. For the economic justification see note 27 supra.
The Securities General and International Utilities cases, however, fall in a third category; for in each of the two companies, the impairment was a result of a dissipation of assets—mostly marketable securities—by a decline in their real values. In such cases it becomes crucial to decide whether the value of the assets has so far declined that the advantages which might be realized by a recapitalization in the nature of a reorganization should be sought. Upon that recapitalization the full loss, under existing reorganization standards, should be visited upon the junior stockholders, and criteria for protection should be readjusted to reflect the changed equities of the various classes of securities. Thus, if the Commission decides, as it did in the International Utilities case, that the recapitalization is advisable, it may ignore the equities of the junior investors which would disappear upon the consummation of the reorganization. It may be assumed that this situation obtained, sub silentio, in the Securities General case. If, however, the need for reorganization is not clearly indicated, dividends on the preferred stock should not be permitted while a common stock impairment remains. In no sense can it be maintained that the common stockholders have assumed the risk of embarrassing payments of preferred dividends. Preferred stockholders have a legal right to the accrual of dividends but not to their immediate payment.

**Conclusion**

The cases under Section 12(c) and those under Section 6(a) indicate that the Commission has made substantial progress in developing a program to protect investors in securities of public utility holding companies and their subsidiaries from losses due to undue withdrawals of assets or improperly balanced financial structures. The level of regulation has passed far beyond that developed in the states. Every case before the Commission represents a situation where the state laws offer no impediment to the issue of securities.

---

86. A reorganization would serve no purpose in cutting down common capitalization unless in addition it provided for a balanced financial structure by (a) cutting down fixed charges, (b) cutting down accrued charges, or (c) paving the way for needed new capital. Unless a reduction of common stock, therefore, makes possible greater facility in new financing, there is no justification for a reorganization even though the common may not be worth much. Under such circumstances the Commission might well redistribute the voting power to reflect the changed present equities, see note 48 supra, but should not proceed to the extent of permitting preferred dividends in the face of a common impairment. Furthermore, if new money is needed it seems probable that the management should not be declaring dividends out of reduced capital. Each situation calls for careful analysis by the Commission.

87. See note 38 supra.

88. It is well settled that a debtor-creditor relationship is not created until the dividend has been declared. Alexander & Alexander, Inc. v. United States, 22 F. Supp. 921 (D. Md. 1938). Directors have broad discretion as to the declaration of dividends. Berle and Means, 189-90; SEC Report, Pt. VII (1938) 112, n. 9.
or the withdrawal of assets. Furthermore, a system operating through the
prevention of distributions by "licensing" provisions is calculated to be
infinitely more effective than one which can be enforced only by remedial
action after the distributions have been made.

A careful scrutiny of the cases, moreover, reveals that the Commission
is appraising each situation from a highly practical viewpoint. Consideration
of the existence of liquidation preferences on the preferred shares, of unsettled
business conditions, pending litigation and adequacy of earning power, of
liquidity of assets, ratio of debt to assets, and soundness of accounting methods,
makes each case an inquiry into the needs and structure of the particular
business. The proceeding is designed, in terms of the particular facts of
the case, to protect the investor adequately, while granting the corporation
the flexibility required for legitimate corporate purposes.

It is this emphasis on individual analysis which explains the deviation
of the decisions from the absolute standard of the rule against impairment.
Thus in the cases involving refunding of preferred stock and bonds the
Commission's position has generally been in excess of the requirements of
the rule of Wood v. Dummer — witness the 15½% added cushion in the North
American case. Conspicuous by its lower standards, on the other hand, is
the Public Service of Colorado case, a decision obviously justified by the
financial strength of the corporation. The "reduction of capital stock" cases,
too, have been characterized by a relaxation of the rule against impairment,
most conspicuously in the Columbia Gas case. Yet among these cases stands
the Green Mountain case, virtually re-enacting the requirements of Wood
v. Dummer.

The Columbia Gas, Public Service of Colorado and North American cases
have provoked the criticism that the Commission has been too lenient in the
conditions it has imposed.89 That is a matter of opinion, to be tested by the
future experience of investors in these companies. But the position some-
times taken by the Commission90 that it should tread lightly in these refund-
sing situations, hardly seems justifiable. These cases, just as much as do
cases involving new issues of securities, present an opportunity and a need
to effectuate the purpose of the Act — protection of investors.91

More susceptible to criticism than alleged practices of leniency are two
policies of the Commission which may tend to recur. One is the predilection

1417, Jan. 25, 1939, were Commissioner Mathews, concurring at 17, and Commissioner
Frank, dissenting in the North American case. But see Note (1938) 33 IIL L. REv.
220. On the North American case, in addition to the dissent of Commissioner Frank, see
Comment (1938) 52 HARV. L. REv. 1331.
90. Cf. Public Service Co. of Colorado, Holding Company Act Release No. 1701,
Aug. 24, 1939, p. 34.
91. The purchasers of securities issued for refunding purposes may well be new
investors.
of the Commission to side-step an absolute valuation of the assets and an absolute decision on the propriety of the corporate program. Thus, in the Columbia Gas case, the ultimate approval of the reduction was left to the vote of the stockholders. The Commission is well aware of the ineffectual power of the proxy machine to effectuate the desires and interests of the stockholders.92

Worthy of serious re-examination, also, is the Commission’s attitude that although there is a strong presumption against the payment of dividends out of capital or unearned surplus, there are less serious obstacles to permitting the payment of dividends to preferred stockholders while common capital is impaired than to permitting payments to common stockholders. In its cases under Section 12(c), the Commission may have been justified in permitting preferred dividends out of capital surplus, when the financial position of the declarant was sound and the impairment was a result of accounting manipulations, or when the need for reorganization was clear. But in its decisions under Section 6(a) the Commission has also consistently imposed restrictions upon common stock dividends but none upon preferred without expressly considering these factors.93 Unless the Commission clearly analyzes the rights of the common stockholder in each case, the latter may suffer irreparable injury, when dividends to preferred shareholders so weaken the financial structure that the full impact of the bankruptcy law is visited on the junior equities.94

These are isolated matters of criticism; it is apparent that the Commission's administration of the distribution problem has been, on the whole, a distinct advance. The success of this experiment may encourage a wider application to large industrial corporations of the principles of protection enumerated under the Holding Company Act. It seems clear that the power to protect investors from improper withdrawals of assets is beyond the ability of the states. Even were the states to see the error of their ways, correction of the existing abuses would be a drawn-out process. So long as one corporate "Reno" remained, the prophylactic efforts of the other forty-seven states would be vitiating.

The control of corporate distributions seems, then, peculiarly fitted to federal control.95 The logical method of control would appear to be an admin-

---


93. This tendency of the Commission is illustrated in Virginia Public Service Co., cited supra note 62; North American Company, cited supra note 57; Green Mountain Power Corp., cited supra note 71; and cases cited supra note 54.

94. This is especially true where the management may be identified with the preferred stock or the common stock is not in the hands of a parent holding company capable of looking out for its own interests.

95. Development of a policy of federal control might require removal of some of the forces at work in the government's tax structure, tending to unbalanced corporate finan-
ISTRATIVE PROGRAM UNDER THE AGIES OF THE SECURITIES AND EXCHANGE COMMISSION. THERE ARE INDICATIONS, HOWEVER, THAT THE TASK OF ADMINISTERING A MORE WIDELY APPLICABLE "SECTION 12(C)" WOULD BE INSUPERABLE WHEN COUPLED WITH THE TREMENDOUS PROGRAM NOW BEFORE THE COMMISSION. WORTHY OF A TRIAL, FOR THIS REASON, IS THE ALTERNATE SUGGESTION THAT THERE BE FORMED, UNDER FEDERAL SUPERVISION, A STOCKHOLDERS' AND BONDHOLDERS' PROTECTIVE COMMITTEE WHOSE BARGAINING STRENGTH MIGHT BE EQUAL TO THE TASK OF DEALING WITH THE FINANCIAL WIZARDS OF THE LARGE CORPORATIONS.


696. Still ahead of the SEC besides its now somewhat routine duties of policing the stock exchanges and scanning registration statements of security issuers are the man-sized job of executing the "death sentence clause" of the Holding Company Act and the exercise of the Commission's duties under the Trust Indenture Act and under the Chapter X reorganization cases of the Chandler Act.


698. The words of Commissioner Frank, dissenting in the North American case, at 29, should be noted:

"I shall make bold, in this opinion, to express my views with some vigor and in detail because it is becoming increasingly evident that protection of investors is essential to the preservation of American democracy. Ours is a profit system, a system cherished by the great majority of Americans. If that system cannot be made to work well, then that majority, including as a major factor the numerous middle class who are investors, may, as in other lands, turn to extremists, of the 'right' or 'left' who will fatuously promise (and with no chance of fulfilment) a better life under some form of dictatorship."