Washington University Law Review

Volume 14 | Issue 3

1929

The Problem of Regulating Payments by Utilities to Holding Companies

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Recommended Citation
Robert B. Snow Jr., *The Problem of Regulating Payments by Utilities to Holding Companies*, 14 St. Louis L. Rev. 299 (1929).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol14/iss3/6

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SAMUEL BRECKENRIDGE NOTE PRIZE AWARDS

Daniel A. Macpherson's note on "The Problem of the Non-resident Transient Motorist" has been awarded the fifteen dollar prize as the best note in the first issue of the current volume.

The award for the best note in the second issue has been made to Joseph Nessenfeld. He wrote on "Survival of Causes for Personal Injuries and Related Wrongs in Missouri."

THE PROBLEM OF REGULATING PAYMENTS BY UTILITIES TO HOLDING COMPANIES

The modern tendency in financial circles is the formation of holding companies for a group of related industries. This is especially true in the public utility field. The relationship between the holding company and the utility is of special importance in connection with its effect on the return the utility earns or is entitled to earn, and hence upon the rate that the public must pay. Payments to the holding company appear as an operating expense, and have caused much worry to the commissions when trying to determine whether the utility is entitled to an increase in rate. The problem that arises in this situation is well stated by Professor Ripley in his book, MAIN STREET AND WALL STREET:[1] "The last serious indictment against the over-developed holding corporation in the public utility field has to do with rate regulation. Under the terrific involution of accounts it may become practically impossible to allocate costs and to determine earnings as related to the investment. The holding company is exposed to the temptation to exploit its subsidiaries, *taking its own profit by undue enhancement of the operating ex-*

[1] (1927), p. 309.

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penses of the local concerns.[2] . . . How easy for the interstate holding companies to dilute earnings in order that they may become digestible in the public view, and how difficult in a massive hierachy of such holding companies to trace anything like costs in relation to investment back to some solid bench mark. How difficult to pass upon the reasonableness of contracts for the use of property or the sale of power. . . . Formal proceedings degenerate under such circumstances into a mere muzz of words."

In order to get a clear picture of just how the holding company has an opportunity to take its profit by undue enhancement of the operating expenses of the local concern, it would be well to consider the so called licensee contract which the American Telephone and Telegraph Co. has with each of its subsidiaries.

A Co., incorporated in New York, is the parent organization and owns most of the common stock of its subsidiaries. X Co., a Missouri corporation, is one of the latter. By the licensee contract X Co. is to pay 4½ per cent.[3] of its *gross* revenue to A Co. which in turn licenses X Co. to use certain patented telephone instruments; the A Co. further agrees to carry on experiments looking toward improvements in the instruments and service, to give X Co. the benefit of such improvements, to defend X Co. in any patent litigation, to aid in financing X Co. at reasonable terms, to act as a central purchasing department, and to give advice in developing the efficiency of X Co. The A Co.'s undertaking does not include payment of taxes on the instruments which it furnishes; these are paid by the X Co. Now suppose that in the year 1926 the gross revenue of X Co. was $20,000,000. On this basis the payment to A Co. would be $900,000; and out of this $20,000,000 must come the actual operating expenses such as wages, materials, supplies, current taxes, plus a fair return upon valuation of the property and an allowance for depreciation. For the purpose of this example, let us place the fair return at $4,100,000, depreciation $2,000,000, and actual operating charges $13,000,000.

Suppose then that in 1927, there had been an increase in cost of material and wages, so that actual operating expenses are $16,000,000 instead of $13,000,000. Clearly X Co. would be entitled to an increase in rates to bring in enough to cover this increased cost of operation. But it would also have to pay more to A Co. under its contract because gross revenue would be increased. If after the increase, X Co. earned $23,000,000, the debit sheet would show: depreciation, $2,000,000 (same as be-

[2] Italics are writer's.

[3] Beginning January, 1929—the charge is only 1¼% but the same principles underlie although the effects are not so glaring even though still there.

fore); actual operating expenses, $16,000,000; payment under licensee contract, $1,035,000; return on value of property, $3,965,000—$135,000 less than it earned the year before and which was found to be what it was legally entitled to earn. Therefore the rates must be increased to provide for the deficit. But it is to be noted that the payment to A Co. was increased by $135,000 without showing any increase in the cost of the service to A Co. or in the benefit to X Co. Nor may this increase in payment be interpreted as a reward for efficiency brought about by the supervision by A Co. If based upon net returns it might well reflect efficiency in management, but it is not. It is based on gross revenue, and whenever this is increased, no matter for what reason, there is an increase in payment to A Co. under the contract, even though the increase in gross revenue has no relation to the service performed by A Co. There is likely to be an exploitation of X Co. by A Co. at the expense of the public.

No one would doubt but what A Co. is entitled to something for its service. But certainly the payment under the licensee contract does not represent the true value of the service, when it can be affected by such forces as those given in the hypothetical situation. Yet the Supreme Court of the United States has repeatedly upheld this type of contract.[4] In *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*[5] the court in speaking of the contract said: "Four and one-half per cent is the ordinary charge paid voluntarily by local companies of the general system. There is nothing to indicate bad faith. So far as appears, plaintiff in error's board of directors has exercised proper discretion about this matter requiring business judgment. . . . The applicable general rule is well expressed in *State Public Utilities Commission ex rel. Springfield v. Springfield Gas and Electric Company*, 291 Ill. 209, 234. The Commission is not the financial manager of the corporation; it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers." This case has generally been considered as limiting the power of commissions to reduce the amount of payment under the licensee contracts to cases where bad faith is shown.[6]

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[4] City of Houston v. Southwestern Bell (1921), 259 U. S. 318; State of Mo. ex rel. Southwestern Bell Telephone Co. v. Public Service Commission (1923), 262 U. S. 216, 31 A. L. R. 80.

[5] See note 3, *supra*.

[6] Southern Bell Teleph. & Teleg. Co. v. R. R. Commission of S. C. (1923), 299 F. 615; Indiana Bell Telephone Co. v. Public Service Commission (1924), 300 F. 190, 204; Chesapeake & Potomac Telephone Co. v. Whitman (1925), 3 F. (2d) 938, 956; Northwestern Bell Telephone Co. v. Spillman

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In the case of *Northwestern Bell Telephone Co. v. Spillman,*[7] the court held that there is a presumption that such licensee contracts have been entered into in good faith and within the directors' proper discretion, and that to overcome this, the commission must show that it was not made within the proper discretion. The opinion further points out that if an unreasonable charge has been imposed on the utility, that would be a circumstance to show an abuse of discretion; but if the charge has been reasonable then it cannot be omitted merely because of the intercorporate relation. Going back to our supposed case. How could the Missouri Commission show that the charge is unreasonable? The Commission itself is not in possession of sufficient information and it cannot compel A Co. to furnish the books and information as to the cost of the service to it.[8] And A Co., being a New York corporation, is not within the jurisdiction of the Commission, so no subpoena *duces tecum* could be issued.

Of course, X Co. is within the jurisdiction and its books might be subpoenaed, but those books would help very little, because they would show neither the cost of the service to A Co. nor the benefit to X Co. But in proceedings before the commissions, before controversies have been brought into court, the commissions have been inclined to throw upon the utilities the burden of showing that the rates are reasonable.[9] The basis for this is that the utility is in a better position to furnish the information than the commission, since the utility could get sufficient information from the parent company. But suppose that the X Co. should make a showing of reasonableness, how could the commission dispute it?

In *Re New York Teleph. Co.*[10] it was held that the refusal of the American Telephone and Telegraph Company to furnish the

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(1925), 6 F. (2d) 663; Citizens Gas Co. of Hannibal v. Public Service Commission (1925), 8 F. (2d) 632; State of Kansas ex rel. Hopkins v. Southwestern Bell Teleph. Co. (1924), 115 Kans. 236, 223 P. 771; Michigan Utility Commission v. Michigan State Teleph. Co. (1924), 228 Mich. 658, 670; re Northern States Power Co. (N. D.) P. U. R. 1924A 325, 346; re New England Telephone & Telegraph Co. (Me.) P. U. R. 1926B 247; re Indiana Bell Telephone Co. (Ind.) P. U. R. 1926C 785, 800; re New England Telephone & Telegraph Co. (N. H.) P. U. R. 1926E 186.

[7] (1925), 6 F. (2d) 663; accord, Re Wisconsin Telephone Co. (Wis.) P. U. R. 1925D 661, 675.

[8] Southern Bell Tel. & Tel. Co. v. R. R. Commission of S. C. (1923), 299 F. 615; Chesapeake & Potomac Teleph. Co. v. Whitman (1925), 3 F. (2d) 938, but see Re Wisconsin Teleph. Co. (Wis.) P. U. R. 1927a 581; where parent company was required to show cost of service.

[9] Chesapeake & Potomac Teleph. Co. v. Whitman (1925), 3 F. (2d) 938; Northern States Power Co. (N. D.) P. U. R. 1924A 325, 346; re New York Teleph. Co. (N. Y.) P. U. R. 1925C 767, 818 *et seq.*

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information as to the cost of the service amounted to the refusal of the utility; was the result that the petitioner was declared not to have made out that the increase in rates predicated in part on the payments to the parent company was just and reasonable.[11] This suggests the possibility of considering the parent and subsidiary companies as one. It is hard to set up any fixed rule as to when the corporate entity will be disregarded. The courts have been vague and uncertain in discussing this. However, it may be said that where stock ownership is resorted to not for the purpose of participating in the affairs of the corporation in the customary and usual manner, but for the purpose of controlling the subsidiary company so that it may be used as a mere adjunct, agency, or instrumentality of the owning company, the court will not permit itself to be blinded by mere corporate form, but will in a proper case disregard the corporate entity and treat the two corporations as one.[12] But what is a proper case? Mere ownership of all of the stock is not sufficient.[13] But the identity of stockholders, the method of conducting corporate business as a separate concern or as a mere department of the other concern, the manner of keeping books, all may be evidential facts to be considered as bearing on the question of whether the corporate entity should be disregarded. But after all, it comes down to a question of whether the corporate entity is being used in good faith and honesty and for legitimate ends.[14]

There are many cases in which the corporate entity has been disregarded. In *Luchenbach S. S. Co. v. W. R. Grace & Co.*[15] the Luchenbach Co. was held liable for the debts of the Luchenbach S. S. Co. The Luchenbach Co. owned 90 per cent. of the stock of the Steamship Co. Further it owned all the vessels which had been leased to the Steamship Co. The latter company has incorporated only for $10,000, which, of course, did not any-

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[10] P. U. R. 1925C 767, 818.

[11] See also Re Wisconsin Telephone Co. (Wis.) P. U. R. 1927A 581 where burden was put on parent company to make showing of cost.

[12] Chicago, M. & St. P. R. Co. v. Minneapolis Civic & Commerce Ass'n (1918), 247 U. S. 490, 501. Also see Henry W. Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 Cal. L. Rev. 12, 17; I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 Col. L. Rev. 496.

[13] N. Y. Airbrake Co. v. International Steam Pump Co. (1909), 64 Misc. (N. Y.) 347, 190 N. Y. S. 683; Chicago, M. & St. P. R. v. Minneapolis Civic & Commerce Ass'n (1917), 247 U. S. 500; Radio-Craft Co., Inc. et al v. Westinghouse Electric Mfg. Co. (1925), 7 F. (2d) 432; McCaskill Co. v. U. S. (1910), 216 U. S. 504; U. S. v. Milwaukee, etc. Co. (1905), 142 F. 247.

[14] Henry W. Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 Cal. L. Rev. 12, 19.

[15] (1920), 267 F. 676.

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where approach the value of the ships used. The court held that the Luchenbach Co. was equally responsible with the Steamship Co. for the latter's breach of contract, saying: "For all practical purposes the two concerns are one."

In *U. S. v. United Shoe Machinery Co. et al.*[16] three companies were joined as defendants, a Maine company, a New Jersey company, and a New Jersey corporation. Motions to dismiss as to the two latter companies were refused, it appearing that the entire capital stock of the Maine company was owned by the New Jersey company and 98½ per cent. of the stock of that company was owned by the New Jersey corporation, and that both companies were *under the absolute control* of the New Jersey corporation. The court says: "The acts of one are the acts of all these corporations, in fact it may truthfully be said that they are the acts of the United Shoe Machinery Corporation. This being so they are properly joined as defendants."

The case of *Chicago, Milwaukee & St. Paul Ry. Co. v. Minnesota Civic Association*[17] also presents another situation where the corporate entity was disregarded. The court says: "Satisfied as we are by the evidence that the Eastern Company is a completely controlled agency of the two companies which own its capital stock, we agree with the Supreme Court of Minnesota that the fact that the legal title to what are obviously terminal or spur delivery tracks is in the Eastern Company should not be permitted to become the warrant for permitting a charge upon the shipper greater than they would be required to pay if that (title) were in the owning companies." In this case the Eastern Company was entirely controlled by the Omaha and Milwaukee companies. These latter two companies elected the board of directors, and dictated the policies of the Eastern Co. The Omaha and Milwaukee companies were the only two railroads operating over the terminal, yet there was a charge for terminal services, which if furnished by the owning companies would have been much less.[18]

If the parent company and all its subsidiary utilities should be considered as one company, then it would be possible to take the cost of furnishing the service to the whole system and distribute it among the various subsidiaries so that each one would bear its just proportion of the costs. This would be the only fair and just way to arrive at a proper payment. The various

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[16] (1916), 234 F. 177.

[17] (1917), 247 U. S. 490.

[18] For some other cases see Specht v. Missouri Pacific R. R. Co. (1923), 154 Minn. 314, 191 N. W. 905; Algot Erickson v. Minnesota & Ontario Power Co. (1916), 134 Minn. 209, 158 N. W. 979; The Anglaize Box Board Co. v. Hinton et al (1919), 100 Oh. St. 505.

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state commissions would have jurisdiction over the parent company and could require it to produce the books. These books could be examined to ascertain what the cost of work done by the parent company is, and then such cost could be prorated among the subsidiaries according to what their just proportion should be. But just there is the rub. If the industry is large as in the case of the American Telephone & Telegraph Co. then with forty-nine regulating bodies it would be practically impossible to reach a proper apportionment of such expenses. The result would be that the contributions authorized to go to the parent company might not cover the expense, or it might be more than the expenses, either of which would leave the situation in as uncertain a condition as the payments under the present licensee contract. Perhaps it is this possibility that has led the Supreme Court to adopt what might be termed the "hands off" policy that it enunciated in the *Southwestern Bell* and *Houston* cases.[19]

This very question came up in the case of *Chesapeake and Potomac Telephone Co. v. Whitman.*[20] The Maryland Commission in a proceeding before it[21] had declared that the American Telephone and Telegraph Co. was the real party in interest, because it owned 100 per cent of the common or voting stock of Maryland Company and controlled the Maryland Company so that the latter was a mere agent, existing and having being only by the grace of the American Company. Further the Maryland Commission took the view that since the Associated Companies of the Bell System were considered as a whole for the benefit and purposes of the owners, they ought to be considered as a whole when the interests of subscribers are at stake. Upon this basis the commission appraised the value of the property of the American Company within its jurisdiction and added it to that of the Chesapeake and Potomac Company in order to arrive at a rate base. Upon an appeal to the Federal court, the commission was reversed as to this point, the court saying that it was inclined to agree with the commission, but that the theory had been disapproved in the *Southwestern Bell* case and the *Houston* case.

The attitude of the Maryland Commission is appealing but due to the exigency of the situation, it is submitted that the Supreme Court is right in refusing to sanction such procedure by the state commissions. The Supreme Court has not attempted to set up the ideal rule to govern the situation, but adopted

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[19] State of Mo. ex rel. Southwestern Bell Telephone Co. v. Public Service Commission (1923), 262 U. S. 276; City of Houston v. Southwestern Bell Tel. Co. (1921), 259 U. S. 318.

[20] (1926), 3 F. (2d) 938.

[21] Public Service Commission v. Chesapeake and Potomac Telephone Co. (Md.) P. U. R. 1925B 545.

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the only course open to it in view of our dual system of government and the problems that it raises. This is just another example of the futility of the present double sovereignty system. It cannot cope with a big problem of this sort. The benefits of one nation-wide telephone system are great and in fact such a unification is practically necessary. Then why not a federal commission to regulate such a system? This brings up the constitutionality of such a commission—a problem beyond the scope of this note.

ROBT. B. SNOW, JR., '30.

RECENT DEVELOPMENTS IN THE RIGHT OF PRIVACY

The recognition of the right of privacy as a complement to the rules of libel and slander in the field of tort law has received a definite stimulus by a recent Kentucky case, *Brents v. Morgan*, decided in 1927.[1] In this case a petition alleging that defendant caused a notice to be placed on a show window fronting on a principal street stating that "Dr. M (plaintiff) owes an account here of $49.67, and, if promises would pay an account, this account would have been settled long ago," was held to state a good cause of action in tort for an unwarranted invasion of the plaintiff's right of privacy. In the decision the court declares its unqualified adherence to the recognition of such a right where the actions of libel and slander are not adequate to meet such situations.

The field of privacy, as such, is of relatively modern development, and has been inadequately treated both in decisions and in text-books. Nor has its scope received accurate and permanent definition to meet the exigencies of a body of law in the process of formation. The principal case defines the right as the "right to be let alone; that is, the right to be free from unwarranted publicity, or the right to live without unwarranted interference by the public in matters with which it is not necessarily concerned." "A more specific but less accurate definition is the right to live without having one's name, picture or statue, or that of a relative, made public against his will."[2] Conceptually treated, the right is one of personal immunity and can have no logical basis as a rule of property.

The right had little or no recognition at early common law, and finds no mention in the classic commentaries. It was involved, directly or indirectly, in a number of cases, but in none was there a complete acceptance or rejection of the right, and

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[1] 221 Ky. 765, 299 S. W. 967.
[2] 21 R. C. L. 1196.

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