res judicata. If the plaintiff sues and alleges only one of several possible claims arising from a given transaction, and if the transaction constitutes the cause of action, then under the doctrine of res judicata, judgment on the pleaded claim bars suit on any other claim arising from the same transaction. This, in effect, would require a plaintiff to join in one suit all claims based on a particular transaction—a result which the drafters of the new rules apparently did not intend.[17]

Public Utility Holding Company Act—Registration of Bond Issue—Effects of Fixed Charge Financing—[Securities and Exchange Commission].—Consumers Power Company, a Maine corporation engaged in the production and distribution of electricity and gas in Michigan, and a wholly owned subsidiary of Commonwealth & Southern Corporation, filed a declaration under the Public Utility Holding Company Act of 1935[1] in regard to the proposed issuance and sale of \$28,594,000 first mortgage $3\frac{1}{4}$ per cent 30-year bonds: \$18,594,000 of which, together with treasury funds, were to be employed in retiring at $104\frac{1}{2}$ a like amount of $3\frac{3}{4}$ per cent first mortgage bonds due 1965; the \$10,000,000 remainder were to reimburse the company treasury for certain property additions.[2] The Securities and Exchange Commission permitted the issuance of the portion to be used for refunding, but, with two dissents,[3] refused to permit the declaration to become effective as to the \$10,000,000 balance,[4] suggest-

[17] Rule 13 (a) compels the defendant to set up in a counterclaim every claim he has arising out of the transaction that is the subject matter of the plaintiff's claim, or be precluded from suing on it in any other proceeding. Since there is no comparable rule governing the plaintiff's joinder of claims, a desirable rule might be to require the plaintiff, as well as the defendant, to settle all claims arising out of the same transaction in one proceeding. See Jones v. St. Paul Fire & Marine Ins. Co., 108 F. (2d) 123 (C.C.A. 5th 1939).

[1] 49 Stat. 803 (1935), 15 U.S.C.A. § 79 (Supp. 1939). The registration provisions of section 15 were held constitutional in Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938). See Buchanan, The Public Utility Holding Company Problem, 25 Cal. L. Rev. 517 (1937); Meck and Cary, Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935, 52 Harv. L. Rev. 216 (1938).

[2] The commission permitted to become effective another portion of the declaration which requested authority to issue 125,000 shares of no-par common stock at \$28.25 per share. The stock was found conformable to section 7 (c) (1) (A) of the holding company act.

Simultaneously, the application of the Commonwealth & Southern Corporation, the holder of all the 1,686,716 shares of stock outstanding, to purchase these shares was dismissed on the ground that under the Rule U-9C-3, C. C. H. Sec. Act Serv. 2115, SEC authorization for a holding company to purchase these shares was unnecessary.

To facilitate a decision on the effectiveness of the registration statements, the commission accepted the offer of the two principal underwriters, Morgan, Stanley & Co. and Bonbright & Co., that they should receive no fees should they be found to be affiliates of the holding company within the meaning of Rule U-12F-2, C. C. H. Sec. Act Serv. 2143. Commissioners Henderson and Eicher dissented in part on the grounds that the issue of the stock failed to comply with the standards of section 7 (d) (6) of the act, and that the acquisition was not exempt under section 10.

[3] Commissioners Mathews and Healy.

[4] The commission granted the company a rehearing, Holding Co. Act Rel. 1854, at 8, (1939), but later, at the firm's request, granted permission to withdraw the declaration as to the \$10,000,000 issue, Holding Co. Act. Rel. 1901 (1940). On Sept. 30, 1939, the com-

ing instead the use of equity financing. *In the Matter of Consumers Power Company.*[5]

While its duties under the Securities Act of 1933[6] are limited largely to promoting proper disclosure,[7] the Securities and Exchange Commission, through the Public Utility Holding Company Act is given, in addition, broad power to regulate the extent and type of financing for public utility holding companies and their subsidiaries.[8] With but two unimportant exceptions,[9] all registered[10] holding companies and their subsidiaries intending to issue securities must file with the commission a declaration describing the proposed issue.[11] This declaration the commission shall not permit to become effective unless under section 7 (c) of the act it finds that

> ". . . . (2) such security is to be issued . . . . solely (A) for the purpose of refunding an outstanding security . . . . (B) for the purpose of financing the business of declarant as a public utility company. . . . ."

By section 7 (d), the commission shall grant approval unless it believes:

> "1. the security is not reasonably adapted to the security structure of the declarant. . . . .
> "2. the security is not reasonably adapted to the earning power of the declarant;
> "3. financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which applicant lawfully is engaged or has an interest; . . . .
> "4. the fees . . . . in connection with the issue . . . . are not reasonable; . . . .
> "6. the terms and conditions of the issue or sale of the securities are detrimental to the public interest or the interest of investors or consumers."

The commission found that the requirements of section 7 (g), that all applicable state laws with respect to an issue be complied with, had been met in regard to all the proposed issues; and that the issue of $18,594,000 was in accordance with section

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pany's capitalization was: funded debt (first mortgage bonds $3\frac{1}{4}$–$3\frac{3}{4}$ per cent due 1965–70), $123,685,000 (51.11 per cent); preferred stock ($4.50 and $5.00), $70,631,024.50 (29.19 per cent); common stock and surplus (1,686,716 shares), $47,660,601.96 (19.70 per cent). Total capitalization, $241,976,626.46.

It is interesting to note that if the proposed issue of 125,000 shares of common stock had been issued, the percentage of common stock and surplus to total investment would have risen from 19.70 per cent to 20.03 per cent even if all $28,594,000 of bonds had been sold. For the 1939 income record, see note 25 infra.

[5] Holding Co. Act Rel. 1854 (1939). The problems of statutory interpretation are discussed in Application of Section 7 (d) of the Public Utility Holding Company Act to "New Money" Security Issues, 49 Yale L. J. 746 (1940).

[6] 48 Stat. 74 (1933), 15 U.S.C.A. § 77a (Supp. 1939).

[7] 48 Stat 78–9 §§ 7 and 8 (1933), 15 U.S.C.A. §§ 77g and 77h (Supp. 1939).

[8] The powers granted are analogous to those granted the Interstate Commerce Commission under section 11 of the Transportation Act of 1920, 41 Stat. 494 (1920), 49 U.S.C.A. § 20a (1929). For the application of this section, see III-A Sharfman, The Interstate Commerce Commission 527 (1935).

[9] Short term notes of small amount are exempt. The commission may also grant certain exemptions, § 6 (b).

[10] For the registration provisions, see § 5.

[11] § 6 (a).

7 (c) (2) (A) and section 7 (d) on the ground that refunding the older series of bonds at a lower rate of interest would be beneficial to the company.

The reasons assigned for the adverse finding under section 7 (d) (3) on the $10,000,000 bond issue were: fixed-charge financing was not necessary for the operation of Consumers' business since it could raise a like amount through the issuance of common stock; such financing was not appropriate since the funded debt of Consumers' constituted, with one exception,[12] a higher percentage of its total capitalization than that of similar utilities[13] located in the Middle West. The commission believed it unwise for the company to sell bonds while equity financing was available, since in the future it might be necessary to raise capital at a time when earnings and the general business situation would be less favorable. The utility could more easily obtain funds at a future time if it had not previously exhausted its credit. In addition, the commission did not want the company to develop a financial structure which might in the future make debt financing "necessary" within the meaning of section 7 (d) (3).

A large proportion of long term bond financing with fixed interest charges is often considered unwise because the management incurs the burden of meeting periodic interest payments regardless of whether the cash position of the company is sufficiently strong to stand the disbursement. During periods of depression the company may be forced to neglect its property in an effort to raise cash. That such acts may prove costly in the long run to the enterprise as a whole only slightly deters the equity holders desperately trying to avoid foreclosure. Further, maturities may come at a time when it is difficult or impossible to retire or refund the bonds becoming due.[14]

The policy of the management in avoiding common stock financing for the operating company may be ascribed to several factors. The introduction of any minority interest opens the way for court actions by shareholders alleging prejudicial conduct by the officers or directors which unduly favors the holding company.[15] Second, the greater the proportion of capital raised through voting securities, the more difficult it is for the holding company to retain control not only as against competing stockholders, but as against the management of the operating company as well.[16] Third, under the present federal income-tax law, interest is an allowable deduction for the corporation.[17]

Two means of financing subsidiaries hitherto unmentioned are available to the holding company: it may invest capital itself in the expansion activities of the subsidiary,[18] or it may plow back earnings of the subsidiary. Under the former method,

[12] The Ohio Power Co., Holding Co. Act. Rel. 1854, at 22 (1939).

[13] Detroit Edison Co., Cleveland Electric Illuminating Co., and Duquesne Light Co., Holding Co. Act Rel. 1854, at 22 (1939).

[14] It should be noted besides that the entire bonded debt of Consumers Power, constituting 51.3 per cent of its capitalization, matures within a five-year period from 1965 to 1970, Holding Co. Act Rel. 1854, at 4 (1939).

[15] See, in general, 13 Fletcher, Cyc. Corp. §§ 5813–58 (perm. ed. 1932).

[16] Berle and Means, The Modern Corporation and Private Property 81 (1932).

[17] Internal Rev. Code § 23 (b), 53 Stat. 12 (1939), 26 U.S.C.A. § 23 (b) (1940).

[18] Of course, it may be possible for the public to own far in excess of 50 per cent of the common stock before control will be lost, Berle and Means, op. cit. supra note 16, at 80. But at some point, a further reduction in percentage of stock owned may become dangerous for those in control.

the holding company is faced with precisely the same problems of retaining control while securing funds by its own equity financing[19] as face it when raising capital for the operating company. When the non-voting securities of holding companies commanded a good market, the difficulty was easily solved through the use of three or four tiers of companies; but this means of financing is now restricted.[20] Reinvesting earnings, on the other hand, is a somewhat slow means of financing and subject to the hazard that a period of low earnings may force at least temporary abandonment of any extensive expansion program. Moreover, dividends from operating companies are usually essential to provide funds to meet the fixed charges of the holding company. Pressure by stockholders of the holding company may well make it difficult to reduce or suspend dividends on its own common stock. Even if such pressure were ineffective, there are strong arguments against such enforced savings by the minority interests.[21]

Hence, it may well be that funds for expansion must be raised by the sale of securities. If the Securities and Exchange Commission is convinced that fixed-charge, non-voting securities represent an evil which must be avoided whenever possible, those in control of sound utilities which are able to and should expand may refuse to do so lest they lose control of their properties.[22] It is even conceivable that the states may be forced into the utility business to provide necessary expansion.

Besides the disadvantages to the management in equity financing, a positive motive for debt financing results from the method of computing the fair return on a public utility. The standard practice, rarely deviated from, is to allow a blanket rate of return on invested capital[23] (perhaps six or seven per cent),[24] regardless of its source. If the equity holders are able to raise a portion of the capital through bonds which carry a lower rate of interest than the rate of return which the utility commission is willing to allow the company, the common shareholders enjoy the difference. They receive a return not only on money invested, but also a return on money borrowed.[25]

The act imposes upon the commission the task of safeguarding the interests of the consumer, the investor, and the public generally.[26] If extensive bond financing makes for inflexible utility rates, both consumers and society as a whole should be concerned, for modern economists contend that an important factor in prolonging the

[19] This argument assumes that the SEC intends to restrict severely the sale of bonds.

[20] Section 11 of the act requires the simplification of utility systems.

[21] Buchanan, Theory and Practice in Dividend Distribution, 53 Q. J. Econ. 64 (1938).

[22] Thus Wendell L. Willkie, chairman of the board, said that the company may abandon expansion plans, N.Y. Times, col. 7, p. 23 (Dec. 29, 1939).

[23] Mosher and Crawford, Public Utility Regulation 241 (1933).

[24] Ibid., at 227.

[25] The book value of the total assets of the company on January 1, 1939, was $270,507,000. Earnings for 1939 were $14,406,000, representing a return of 5.3 per cent. After paying interest charges and dividends on preferred stock, there remained $6,250,000 for the $46,998,000 equity; thus, there was a return of 13.2 per cent to the common shareholder, 6 Poor's Financial Records, no. 164, at 4028 (Nov. 21, 1940). Through the use of holding companies, the rate of return is subject to fantastic expansion, Cohen, Confiscatory Rates and Modern Finance, 39 Yale L. J. 151, 152 (1929).

[26] § 7 (d) (6).

present depression has been the inflexibility of a portion of the price structure.[27] As the allowable rate of return for a utility is based on the total capital employed with little regard to source, the rate would probably not be immediately affected by an increase of equity financing. If greater difficulty in securing adequate capital were encountered by virtue of a decline in the rate of return on utility stocks, utility commissions might be compelled to increase the allowable rate of return. As increasing proportions of the capital are raised through common stock, however, the risk of foreclosure and the burden of fixed charges become less, and hence the return necessary to attract capital should become less. Which of these tendencies would predominate it is impossible to predict.

During the recent depression, utility commissions, in response to considerable pressure, frequently reduced rates,[28] sometimes expressly repudiating the "overall" method of computing rate of return, at least for the duration of the emergency, and adopting the plan of computing the amount necessary to meet fixed charges and then adding a sum sufficient to pay a dividend of five or six per cent on the common stock.[29] Under this system, since (theoretically) the common stock dividend rate exceeds the interest rate on high-grade bonds, the larger the proportion of bonds to the total capitalization, the smaller will be the aggregate cost of capital necessary for a fair return, and hence, the lower the rates to consumers. But it is questionable whether rates will be lower than if only common stock financing were employed; for not only is there the possibility that the bonds will have been issued during prosperous times and thus carry high interest rates, but the common stock will require a higher rate of return because of the additional risk and the burden of fixed charges.

As to investors, it may be argued that in a competitive society the commission's task should be limited to effectuating adequate disclosure. But the commission may be convinced that competition is not a completely effective safeguard to investors, although if judged by traditional standards, Consumers Power bonds are secure investments.[30] Price level changes may cause a marked disparity between the purchasing power of the money lent and that repaid. The management of a debtor firm may be driven to exhaust the liquid assets of the business in an attempt to meet fixed charges, in order to prevent a receivership or foreclosure which would result in the destruction of the residual equity. Upon foreclosure, the bondholders would eventually come into possession of property which, in order to pay the bond interest, has been allowed to deteriorate. Working capital, moreover, is likely to be inadequate. The bondholders may find, in effect, that a portion of their investment has been repaid in the form of interest. That these dangers are not visionary is evidenced by the history of

[27] Sumner, Public Utility Prices and the Business Cycle; a Study in the Theory of Price Rigidity, 21 Rev. of Econ. Statistics 97 (1939).

[28] In re Wisconsin Tel. Co., [1932 D] Public Util. Rep. 173 (Wis.). In Public Service Comm'n of Wisconsin v. Wisconsin Tel. Co., 289 U.S. 67 (1933), the Supreme Court vacated an injunction granted by the district court.

[29] In re Wisconsin Tel. Co., [1932 D] Public Util. Rep. 173 (Wis.); Dep't of Public Works v. West Coast Tel. Co., [1933 A] Public Util. Rep. 487 (Wash.); cf. In re New Haven Water Co., [1932 E] Public Util. Rep. 97 (Conn.).

[30] Both Moody's and Poor's give Consumer bonds the second highest rating (Aa), Poor's Utilities 755 (1939); Moody's Public Utilities 706 (1939).

the railroads.[31] Utility investors probably fared better during recent years than they otherwise might have because the market for electrical energy was expanding.[32] Perhaps the commission feels that such a fortuitous circumstance cannot be relied upon to protect the investor in the future.

The new Consumers Power bonds yield the low rate of 2.97 per cent.[33] If the interest rate on securities of equal soundness should rise, the market price of these bonds will decline.[34] Consequently, the maintenance of principal intact, so important for banks and trustees, may not be feasible in the case of low yield investments. But even though a trustee or bank appreciates the danger of the traditional form of investing, the pressure of public opinion together with express statutory restrictions[35] operates to prevent a change in customary investment policy. Even without these restrictions, trustees would hesitate to invest in the common stock of companies free of bonded indebtedness if it is true that the indebtedness of other firms makes for such instability in the whole economic system that the common stock of all firms is an insecure investment.

During crises, the rush to liquidity in order to meet maturing obligations results in hoarding which accelerates the decline of prices.[36] The commission may desire to check these cumulative maladjustments by reducing the amount of fixed-maturity securities. While the scope of its authority is limited, its authority does comprehend the public utility industry which has extensively used this means of financing. The security given to a few investors may be more than counterbalanced by the general insecurity to society as a whole and ultimately to the favored class itself.

[31] Moulton, The American Transportation Problem (1933).

[32] Moody's Public Utilities *a*16 (1939).

[33] Holding Co. Act Rel. 1854, at 3 (1939).

[34] See McDiarmid, Plain Talk on Debt Retirement from a Utility Bond Buyer, 24 Pub. Util. Fortnightly 67 (1939). If the interest rate should rise to 4 per cent while these $3\frac{1}{2}$ per cent bonds have 25 years to run, the bonds (theoretically) will decline to $92.14 (assuming interest is paid semi-annually):

(Present val. of bond) (Present val. of interest)

$$100\left(\frac{1}{1.02}\,50\right) + 1.75\left(\frac{1-\frac{1}{(1.02)}\,50}{.02}\right) = 37.152788 + 1.75\,(31.4236059)$$

$$= 37.15 + 54.99 = \$92.14.$$

[35] The statutes are summarized in 3 Bogert, Trusts and Trustees § 616 et seq. (1935).

[36] Simons, Rules versus Authorities in Monetary Policy, 44 J. of Pol. Econ. 1 (1936). The extent of hoarding might perhaps be reduced by stiff sinking fund requirements. But under the Consumers trust agreement, only $\frac{1}{2}$ of 1 per cent of the total bonded indebtedness is to be retired each year, Moody's Public Utilities 707 (1939).