A COOPERATIVE PROGRAM

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The purpose of this article is to outline a specific program for co-operation between business and Government in the financial rehabilitation of a substantial part of the utility industry. The project is to unfreeze, by means of recapitalization, the capital structures of many units of this vast industry, substantially a half of which, measured by assets, is now bogged down in a morass of accumulated unpaid dividends amounting to some $432,000,000 on about a billion and three-quarters par value of preferred stock. Substantially 46 per cent of the $3,860,000,000 of the preferred stocks of registered holding companies and their subsidiaries outstanding in the hands of the public are in arrears.

The correction of this situation will serve the three-fold purpose of opening the way for resumption of dividends, of facilitating new financing for construction, and of creating sound financial structures on which to build for the future.

The implications of these figures must be faced. They do not appear to have been faced even by the industry. In effect, they virtually forbid equity financing to about half the industry, since, plainly enough, investors will not invest without hope of return. They preclude the use of earnings for dividend payments, since, often, companies which cannot finance must keep earnings for corporate purposes. In addition, many of the companies which have any accumulated and unpaid dividends on their preferred stock cannot legally pay dividends.

The accumulations stand in the way of that full revival of public confidence and trust in the utility industry which cannot come until there is a rebuilding of unsound financial structures. Whatever other burdens rest heavy on the industry's back, the hand of this accumulation is by far the heaviest. The accomplishment of this program is pressingly necessary. The task is of a kind we have elsewhere mentioned -- an "obvious thing to do first" if the industry is to make great progress toward setting its house in order. Also it supplies a concrete situation for the application of the best cooperative endeavors of which the industry and this Commission are capable.

In other days, conditions of this character were corrected by a process of private bargaining which was often palpably inequitable. The history of reorganization is replete with proof of that contention. To prevent the recurrence of such abuses in the utility industry is a responsibility of this Commission. The law now sets up certain standards, and the task of cooperators necessarily lies within the framework of those standards.

Within the statutory framework, reorganizations and refinancing should proceed in an orderly, equitable fashion. Under the new system, they should be constructive and beneficial to the industry, to investors and to consumers. These ideas serve to illustrate concretely why the Commission calls this statute constructive. The destructive way is the old way, a way which was directed with little or no heed except to that interest which was able to dominate.

Sound recapitalization programs mean that the flow of earnings from the utility industry to investors will be resumed. We all know that the utility industry is an earning industry, as strong or stronger than any in the nation, not in the least decadent. It is a thriving industry, and still young.

Recapitalization is the most serious task currently confronting the utility industry and this Commission. It is primarily a reconstruction job which will require recognition from all the interests involved that they must exchange their weak securities for securities that will stand up in the market to the end that they may again receive that which they are not now receiving -- a return on their investment. The earnings are there; the sound properties are functioning efficiently; there is more to be gained than can be lost by delay.

The present financial problems of the industry had their origin in the fair-weather policies of finance which for many companies reached an all-time peak of irresponsibility in the late '20's. The Holding Company Act did not create the situation. It is a result, not a cause, of this financial headache, and it is also a prescription for cure.

In spite of the relative stability of the electric and gas industries, the depression not only completely wiped out the income of the common shareholders in many holding companies but also yielded insufficient income to pay holding company preferred dividend requirements. This came about not merely because of the reduction of gross earnings, but also because of the tremendous over-capitalization of electric and gas companies. Bonds and preferred stocks, carrying with them an inexorable charge upon earnings, were freely issued. When the storm broke, therefore, the companies could not continue to meet the demands upon their earnings. Some defaulted on fixed interest charges, but a great many failed to pay preferred dividends. In terms of the national situation, the latter present the most pressing problem.

Here are the detailed figures: On January 1, 1938, out of 158 holding companies having outstanding preferred stocks with a par or liquidating value of $2,413,255,930, there were 48 companies with outstanding preferred stocks of $1,330,616,237 which were in arrears as to dividends to the extent of $336,657,749.

The arrearages represent an average accumulation of 25.3% of the par or liquidating value of the stocks, or more than 4 years' dividends. It will also be noted that more than half of the par value of the outstanding preferred stocks of these holding companies have accumulated arrearages.

Turning now to the operating subsidiaries of registered holding companies, there were 224 companies with preferred stocks in the hands of the public amounting to $1,447,460,196 par value. Of these, 70 companies, having $442,976,005 par value of preferred stock, were in arrears to the extent of $95,745,276. Thus over 30% of the par value of the subsidiaries' preferred stocks held by the public are in arrears. The amount of arrears averages 21.61% or over three years' dividends.

In most cases, it will probably be some years before earnings are sufficient to eliminate these arrearages. Until the arrearages are eliminated in some way, these companies cannot do their financing job nor can dividends be paid on the common stocks. In a great many instances, recapitalization will be necessary. Typically, the financially weak holding-company systems have an excessive amount of senior securities outstanding. In many cases the parent company has some debentures and a large issue of preferred stock with three or four years of accumulated unpaid dividends. The parent company's common stock represents a relatively small part of the total consolidated capitalization, but it enjoys all or a majority of the voting control. It is obvious that there are reasonable limits to the amount of pyramiding that may safely be allowed in utility holding company structures.. It is equally obvious that these limits have been greatly exceeded in many instances. Thus only a small decline in the rate of return on the operating companies' properties has caused the huge accumulations of dividend arrearages which now exist. Clearly, then, our present task is to cooperate in reconstructing these unsound financial systems. The requirements of the Holding Company Act, particularly relating to the issuance of securities and the acquisition of properties, should prevent a recurrence in the future of such widespread financial difficulties.

Consider in more detail some of the effects of the weak financial condition of holding company systems. If utility operating companies are to continue to fulfill their obligations to the public they must be able to obtain relatively large sums of money through the sale of new securities. A considerable part of the new money should be raised through the sale of additional preferred and common stock. If operating companies are to obtain equity money, they must be able to sell their own securities directly, or perhaps indirectly, to the public. Those companies, therefore, with large arrearages on their preferred stocks must undergo a readjustment of their capital structures in order that such earnings as are available may be equitably distributed to their shareholders and the securities placed on a basis that will attract new money.

Here then is the industry's dilemma.. We are reliably informed that with a revival of business the operating companies should resume their construction programs on a basis approximating the 1923-1930 level of 7 to 8 hundred million dollars annually. While a substantial amount of the funds would come from current earnings, including accruals to depreciation and retirement reserves, it is probable that new financing would be required to the extent of 350 to 450 million dollars annually. Yet without recapitalization, many companies would be unable to sell such additional common stocks as would be necessary to insure a proper proportion of equity money in new construction programs.

We have no illusions as to the difficulties of effectuating voluntary reorganizations. Ordinarily such recapitalization plans are devised by the management. The management, in almost every instance, has been placed in office by the votes of the common stock and frequently is financially interested as well. Recapitalization plans, formulated under such auspices, while calling for sacrifices by the common stockholders usually in the form of a dilution of their interest in the equity of the company, have invariably called for disproportionately large sacrifices by preferred stockholders.

This is another reason why we have this statute. These abuses did occur in the past. They might occur again were they not scrutinized by an agency representing the public and investors. The Securities and Exchange Commission is the agency in this case. Under the Holding Company Act, solicitations of proxies or consents regarding any reorganization plan may not be made unless they are accompanied by a copy of the Commission's report on the plan or the plan has been proposed by the Commission itself. Whether or not the required number of consents are obtained, approval by the Commission is required for the issuance of the new securities, pursuant to Section 7. And the Commission is obliged to withhold such approval if it finds that the issue is not adapted to the security structure and earning power of the declarant or otherwise does not comply with the statutory standards.

Needless to say, the intervention of the Commission in this situation will not produce perfect plans. There is no such thing as a perfect plan. The question in every case is whether "the bargain made is, under all the circumstances, within the permissible limits indicated by the rights and priorities of the various classes" of securities 1/. Virtually always there is room for legitimate disagreement in reorganization, voluntary or otherwise. But in spite of the absence of hard and fast rules, this principle is clear: The Commission will not permit any particular group to profit unfairly at the expense of other interests.

On the basis of the standards set by the Act, the Commission is ready to cooperate in the formulation of sound recapitalization plans. Our policy in this, as in all matters under the Act, is to place our staff at the industry's disposal with a view to discussing their problems informally. Thus when a plan is presented to the Commission, the applicant will have had the views of the staff concerning the equities of the situation and the requirements of the law. To be sure, the ultimate decision will rest with the Commission. Nevertheless, we feel that this is a helpful procedure. It tends to overcome the frequent complaint of businessmen that they can never get from an administrative department of the Government an indication as to whether or not a proposed course of action is in the right direction.

Many members of the industry have already expressed their realization that cooperation is an effective technique. It is needless to emphasize that this job must be done. We have urged the industry to assume leadership. And that leadership seems to be emerging. But whoever leads, this job remains as one of the most pressing ones.

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1/ *In the Matter of the Application of International Paper and Power Co.* (1937) Holding Company Act Release No. 770.

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