european corporate governance institute

The Corporate Pyramid Fable

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The authors are grateful for feedback from participants at faculty workshops at Columbia Law School and University of Minnesota Law School, including Joshua Blank, Michael Graetz, Michael Knoll, Wojciech Kopczuk, Ruth Mason, Alex Raskolnikov, Chris Sanchirico, and David Walker, for discussions with Reinier Kraakman and Mihir Desai and for the research assistance of Amy Atchison, John Baptie, Drew Capurro, and Yuriy Rubanov. Joe Doherty also provided assistance with data analysis.

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Abstract

In many parts of the world, it is commonplace for wealthy families and successful entrepreneurs to parlay a relatively small financial investment into control of a sprawling corporate empire through the use of a pyramid-like structure in which they directly control a firm that owns a dominant stake in a company or companies with outside investors, which in turn controls other firms in the same manner and so on. In the United States, however, corporate pyramids are the exception to the rule. Why is this controversial business arrangement, stigmatized as a device economic elites use to disguise market power and manipulate government, largely absent from the U.S. corporate landscape? The conventional wisdom is that they were dismantled by New Deal policymakers who introduced in 1935 a tax on dividends paid to corporate shareholders. We show that this version of events is more fable than truth, relying primarily on a hand collected dataset drawn from filings made with the Securities and Exchange Commission between 1936 and 1938 by companies owning 10% or more of shares of companies registered with the Commission. We account for the rarity of corporate pyramids in the U.S. largely in terms of history, indicating that prior to the New Deal they were only ever extensively used in the utilities sector, where elimination of pyramidal structures was driven primarily by the Public Utilities Holding Company Act of 1935. Tax may have had an effect on corporate structure, but, at least in this instance, it was not the great leveller that the corporate pyramid fable would suggest.

Keywords: history of U.S. corporate structures, publicly traded corporations, Public Utilities Holding Company Act of 1935

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THE CORPORATE PYRAMID FABLE

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Abstract

In many parts of the world, it is commonplace for wealthy families and successful entrepreneurs to parlay a relatively small financial investment into control of a sprawling corporate empire through the use of a pyramid-like structure in which they directly control a firm that owns a dominant stake in a company or companies with outside investors, which in turn controls other firms in the same manner and so on. In the United States, however, corporate pyramids are the exception to the rule. Why is this controversial business arrangement, stigmatized as a device economic elites use to disguise market power and manipulate government, largely absent from the U.S. corporate landscape? The conventional wisdom is that they were dismantled by New Deal policymakers who introduced in 1935 a tax on dividends paid to corporate shareholders. We show that this version of events is more fable than truth, relying primarily on a hand collected dataset drawn from filings made with the Securities and Exchange Commission between 1936 and 1938 by companies owning 10% or more of shares of companies registered with the Commission. We account for the rarity of corporate pyramids in the U.S. largely in terms of history, indicating that prior to the New Deal they were only ever extensively used in the utilities sector, where elimination of pyramidal structures was driven primarily by the Public Utilities Holding Company Act of 1935. Tax may have had an effect on corporate structure, but, at least in this instance, it was not the great leveller that the corporate pyramid fable would suggest.

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I. Introduction

A key issue in research on corporate governance has been the economic consequences of the legal and institutional setting in which companies operate.[1] Within this body of literature, the ownership structure of publicly traded corporations has featured prominently, with researchers seeking to explain the outcome of dispersed and concentrated ownership and stock market development more broadly.[2] A popular thesis is that law is the primary determinant of ownership structure, with the robust legal protection of investors of the sort offered in the U.S. encouraging dispersed share ownership while weaker legal protection elsewhere has ensured the perpetuation of concentrated ownership.[3]

While the determinants of ownership patterns in public companies have been studied in some detail, the corporate pyramid is an important ownership variant that has only recently started to attract attention. Corporate pyramids are not common in the U.S., but are widespread in many parts of the world. The typical arrangement is for a group of firms – usually publicly-traded – to be under the control of a successful entrepreneur or wealthy family with a relatively small financial stake in the overall operation.[4] Those at the apex exercise corporate power and influence disproportionate to their investment through a chain of ownership relations in which

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[1] Michael Ryngaert & Ralph Scholten, *Have Changing Takeover Defense Rules and Strategies Entrenched Management and Damaged Shareholders? The Case of Defeated Takeover Bids*, 16 J. CORP. FIN. 16, 16 (2010).

[2] Arthur R. Pinto, *Globalization and the Study of Comparative Corporate Governance*, 23 WIS. INT'L L.J. 477, 491 (2005).

[3] *See, e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 511-13 (1999) [hereinafter La Porta et al., *Corporate Ownership*]; Rafael La Porta, Florenio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta et al., *Law and Finance*]. On the prevailing wisdom concerning ownership patterns in the U.S., see Marco Becht & Colin Mayer, *Introduction*, *in* THE CONTROL OF CORPORATE EUROPE 1-2, 20, 36-37 (Fabrizio Barca & Marco Becht eds., 2001); Christoph van der Elst, *The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?*, *in* CAPITAL MARKETS AND COMPANY LAW 3, 4-5 (Klaus J. Hopt & Eddy Wymeersch eds., 2003).

[4] *Pharaoh Capitalism*, THE ECONOMIST, Feb. 12, 2009, at 90; Heitor V. Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Family Business Groups*, 61 J. FIN. 2637, 2637 (2006).

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they directly control a firm that owns a dominant stake in a company or companies with outside investors, which in turn controls other firms in the same manner and so on in a pyramid-like structure. The corporate pyramid in turn can provide the platform for sprawling business empires.

The dearth of corporate pyramids might well be considered one of the more positive features of the U.S. corporate landscape. Corporate pyramids provide opportunities for those at the apex of the pyramid to exploit companies lower in the corporate chain, in which they have a relatively small economic stake, at the expense of the minority shareholders of those downstream companies. Corporate pyramids also may generate negative societal effects. Business groups of this type have been stigmatized as "structures that permit tiny elites to use public shareholders' wealth to control the greater parts of the corporate sectors of some countries."[5] Moreover, purportedly "pyramidal control can disguise market power, frustrate tax authorities and manipulate government."[6]

The literature on complex business groups identifies benefits as well as costs associated with corporate pyramids.[7] For a successful entrepreneur or wealthy family, operating via a corporate pyramid makes good sense because they can, with a limited capital investment, exploit opportunities financially constrained rivals cannot and diversify risk by moving into new economic sectors. For investors, buying shares in firms affiliated with a corporate pyramid provides an opportunity to ride the coattails of success. Still, while the pros and cons of

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[5] RANDALL MORCK, *How to Eliminate Pyramidal Business Groups: The Double Taxation of Intercorporate Dividends and Other Incisive Uses of Tax Policy*, *in* TAX POLICY & THE ECONOMY 135, 136 (19th ed. 2005) [hereinafter MORCK, *How to Eliminate*].

[6] Randall Morck, *The Riddle of the Great Pyramids* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 14858, 2009) [hereinafter Morck, *Riddle*].

[7] Ronald W. Masulis, Peter Kien Pham & Jason Zein, *Pyramids: Empirical Evidence on the Costs and Benefits of Family Business Groups Around the World* 3 (Eur. Corp. Gov. Inst., Working Paper No. 240, 2009) [hereinafter Masulis et al.].

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corporate pyramids are known, no formal theory explains their presence or absence in different countries.[8] The U.S., due to its dearth of corporate pyramids, provides a crucial case study for those seeking to understand what accounts for their position on the corporate landscape.

Definitive answers are lacking for what has been characterized as "The Riddle of the Great Pyramids"[9] but the nature of regulation stands out as a plausible explanation for the prominence of pyramidal groups (or lack thereof). The most obvious hypothesis is that corporate pyramids will be particularly common in countries with poor investor protection and inadequate rule of law, neither of which is characteristic of the U.S.[10] The logic is that pyramidal groups are associated with the expropriation of minority shareholders, and weak investor protection generates an environment where "tunnelling" by dominant shareholders can occur readily.[11] There has been little direct testing of this hypothesis, perhaps due to the fact that the link between pyramidal groups and the expropriation of minority shareholders has been treated as axiomatic.[12] A recent 45-country study of family business groups and corporate pyramids by economists Ronald Masulis, Peter Pham and Jason Zein indicates, however, that the quality of corporate law and related governance rights does not have any effect on the prevalence of complex business groups such as corporate pyramids.[13]

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[8] Almeida & Wolfenzon, *supra* note 4, at 2638.

[9] Morck, *Riddle*, *supra* note 6.

[10] On the rule of law and investor protection in the U.S., see John Armour, Bernard S. Black, Brian R. Cheffins & Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 689 n. 9, 711-14 (2009).

[11] On this formulation, see Tarun Khanna & Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LIT. 331, 343 (2007).

[12] *Id.* at 346.

[13] Masulis et al., *supra* note 7, at 33, 36, Table I (defining "Governance Index").

While investor protection (or lack thereof) apparently does not account for the prominence of pyramids as a feature of the corporate landscape, another form of regulation is generally thought to be influential. The assumption is that tax, and in particular the tax treatment of dividends received by corporate shareholders, does much to explain why corporate pyramids are a rarity in the U.S. while being commonplace elsewhere. Specifically, taxation of intercorporate dividends -- imposed during the New Deal and remaining in place today -- prompted pyramids then in existence to unravel and dissuaded new pyramidal structures from forming. In this paper we investigate this thesis, and find it wanting in material respects. We argue that tax reform had at best a modest impact on corporate structures and that the primary reason that corporate pyramids are the exception to the rule in the United States is that they have never been a hallmark of U.S. corporate governance. Hence, the tax explanation for the demise of corporate pyramids is more fable than truth.

Economist Randall Morck is the most forceful advocate of the theory that the paucity of corporate pyramids in the U.S. is due to the taxation of intercorporate dividends. He argues the introduction of this form of tax in 1935 "induced a rapid dismantling of American business groups. Previously an important part of the large corporate sector, business groups seemingly all but vanished by the end of the 1930s."[14] This, Morck argues, was sound public policy. He, as with other critics of corporate pyramids, says they concentrate corporate control counterproductively in the hands of wealthy individuals or families.[15] Due to the wisdom of New Deal policymakers the United States rid itself of this particular corporate governance affliction. As Morck says "The New Dealers were sweepingly successful for business groups all

[14] MORCK, *How to Eliminate*, *supra* note 5, at 168.

[15] *Id.* at 164.

but disappeared from the U.S. corporate landscape."[16] The benefits arguably continue to accrue to this day. Morck and fellow economist Bernard Yeung have said of the dearth of corporate pyramids in the U.S. "America's intercorporate dividend taxation rules is (*sic*) probably a key, though largely unappreciated, reason for this exceptionalism."[17]

The conjecture that tax is a key determinant of corporate ownership structure in this particular context is difficult to test empirically, at least on a comparative basis. Due to the rarity of intercorporate taxation of dividends – Masulis, Pham and Zein report that only three of the 45 countries in their sample have this form of taxation -- there is insufficient cross-country variation to include this factor as a variable in regressions designed to identify country-level characteristics that may explain the prevalence of corporate pyramids.[18] Nevertheless, with respect to the United States, it should be possible to test by historical means the impact intercorporate taxation of dividends had on corporate pyramids. That is the approach we adopt in this paper.

Intercorporate taxation of dividends became a permanent feature of the U.S. tax landscape in 1935. Correspondingly, to assess the impact of this change we rely on a pioneering hand-collected dataset based on filings made between 1936 and 1938 with the Securities and Exchange Commission by investors owning 10% or more of shares of corporations registered with the Commission. To the extent that the received wisdom concerning tax and corporate pyramids is correct, the introduction of taxation on intercorporate dividends in 1935 should have prompted the rapid unwinding of corporate-held ownership blocks in public companies, thus causing the simplification of complex group structures, including pyramidal arrangements.

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[16] *Id.*

[17] Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, 174 (2005).

[18] Masulis et al., *supra* note 7, at 34.

Our results indicate matters worked out much differently. Although politicians may have supported the intercorporate dividends tax because they believed that it would induce corporations to unwind stakes held in other publicly traded corporations, tax reform apparently did not have that effect. Corporations that owned large stakes in publicly traded firms rarely sought to exit in the years immediately following the introduction of intercorporate taxation of dividends, and many corporations even increased their ownership stakes in other corporations. A key reason the introduction of intercorporate taxation of dividends did not have the anticipated impact was that the tax burden was so modest. Although dividends by one corporation to another corporation were no longer completely tax-free, they remained largely exempt.

If the thesis that tax caused the dismantling of pyramidal arrangements ultimately is more fable than truth, why are complex corporate groups apparently so rare in the U.S.? History likely played an important role. There is a dearth of pre-1935 data on the extent to which corporations were major holders of stock in publicly traded firms. However, the available evidence suggests that, the utilities sector aside, corporate pyramids were not an endemic feature of corporate ownership in the U.S. prior to the introduction of intercorporate dividend taxation. Correspondingly, there simply were not a large number of corporate pyramids for tax to hit and those that did exist were typically dismantled as a result of the Public Utility Holding Company Act of 1935.

In making this claim we are not suggesting tax was irrelevant to the nature and extent of corporate ownership of shares. During the mid-1930s U.S. lawmakers introduced various changes to the law intended to simplify complex corporate structures and these likely did prompt a response. However, with corporate pyramids, or more correctly the lack thereof, intercorporate taxation of dividends was not a decisive factor.

The paper is organized as follows. Part II sets the scene by providing a taxonomy of corporate structures and identifying the distinctive features of corporate pyramids. Part III summarizes the thesis that the introduction of intercorporate taxation of dividends in the mid-1930s explains why corporate pyramids are a rarity in the U.S. and indicates the empirical evidence that has been tendered to support the thesis is weaker than appears to be the case at first glance. Part IV describes the empirical test we carry out using S.E.C. ownership data and outlines how our finding that most corporate shareholders stood pat casts doubt on the intercorporate taxation of dividends thesis. Part V considers reasons why the status quo was the order of the day despite the new tax arrangements. Part VI uses history to explain why corporate pyramids have been the exception to the rule in the U.S. despite the minimal impact of intercorporate taxation of dividends, indicating that, the utilities sector aside, pyramidal groups were never commonplace. Part VII accounts for the demise of corporate pyramids in the utilities industry, the one sector where pyramidal structures were prominent. Part VIII concludes.

II. Distinguishing Corporate Pyramids from Analogous Corporate Structures

To put our analysis of intercorporate taxation and corporate pyramids into proper context, it is first necessary to distinguish pyramidal arrangements from potentially analogous corporate structures. Morck cites 3M, the Minnesota-based technology firm, as the "Typical Large United States Corporation", indicating that a corporation of this nature will have various wholly owned subsidiaries but will rarely hold meaningful stakes in any publicly traded enterprises.[19] This sort of firm, as Table 1 indicates, is often referred to as a parent company. A parent company can be

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[19] MORCK, *How to Eliminate*, *supra* note 5, at 138, 143. There may be exceptional circumstances where a parent company will hold less than 100% in subsidiary companies. For instance, while Ford Motor Company has traditionally operated through 100% owned foreign subsidiaries, as of the mid-2000s it held only a 34% stake in Japanese carmaker Mazda: PETER T. MUCHLINSKI, MULTINATIONAL ENTERPRISES & THE LAW 56-57 (2d ed. 2007).

distinguished from the simplest corporate structure -- a pure operating company -- because aspects of business activity will be carried out by subsidiary companies the parent company owns rather than directly by the company itself.

If a parent company lacks any operating aspect, in the sense it does not make, sell or distribute a commodity or service, it can be categorized more appropriately as a "pure" holding company.[20] A cousin to the pure holding company is the investment company, which also has no operating company aspect. However, investment companies typically own stock in publicly traded companies exclusively whereas many holding companies will only have wholly owned subsidiaries and few have stakes in a wide-ranging portfolio of public companies.[21] Moreover, a holding company, unlike an investment company, will usually do more than "hold" the shares and instead will perform various services on behalf of the companies in which it owns shares and may well supervise operations generally.[22] Hence, a "holding company occupies a position midway between a mere investing organization and one absolutely controlling the activities of other corporate enterprises."[23] Though the "Typical Large United States Corporation" may be a parent company, various major present day U.S. public companies are holding companies, such as Berkshire Hathaway (owner outright of a series of insurance companies and of sizeable

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[20] CHARLES S. TIPPETTS & SHAW LIVERMORE, BUSINESS ORGANIZATION AND PUBLIC CONTROL 168 (2d ed. 1941) [hereinafter TIPPETTS & LIVERMORE (1941)].

[21] For example, the conglomerates that became a major force in the U.S. economy in the 1960s by acquiring sizeable numbers of companies operating in largely separate market sectors usually acquired a 100% stake in the firms they bought. Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 16, 28 (2008).

[22] JAMES C. BONBRIGHT & GARDINER C. MEANS, THE HOLDING COMPANY: ITS PUBLIC SIGNIFICANCE AND ITS REGULATION 14-15 (1932); *Holding Companies' Activities Explained*, N.Y. TIMES, Apr. 4, 1926, at E12.

[23] G. Lloyd Wilson, *Book Review*, 165 ANNALS AM. ACAD. POL. & SOC. SCI. 236, 236 (1933).

minority stakes in a handful of carefully selected publicly traded companies),[24] UAL Corp. (owner of United Air Lines Inc.)[25] and AMR Corp. (owner of American Airlines).[26]

Table 1: Taxonomy of Corporate Organizations

Type of corporate organizations	**Ownership of shares in other companies?**	**Ownership of sizeable stakes in publicly traded companies**	**Company at apex operating most/all of assets under its control**	**Nature of cash flow upwards to company at the apex of the group**
Pure operating company	No; the company may be organized as divisions but these will not have separate legal personality.[27]	No	Yes	N/A
Parent company (operating company with a holding company aspect)	Yes	Rarely.	Yes	Typically dividends and capital gains if a subsidiary is sold.
"Pure" holding company[28]	Yes	This can occur but investing in a wide range of public companies is a hallmark of investment companies, not	No; it would not be a "pure" holding company otherwise.	Same as for a parent company plus fees charged for provision of marketing services, technical advice, financial

[24] On the nature of Berkshire Hathaway, see *Preaching to the Converted: Berkshire Hathaway*, THE ECONOMIST, May 7, 2005, *available at* http://www3.economist.com/research/articlesbysubject/displaystory.cfm?subjectid-=348960&story_id=E1_PJQTVQJ.

[25] *UAL Corporation Reports Third Quarter 2009 Results* (Oct. 20, 2009), http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzU1MTA0fENoaWxkSUQ9MzQ1OTE5fFR5cGU9MQ==&t=1.

[26] AMR Corporation – American Airline's Parent Company, http://www.aa.com/i18n/amrcorp/corporateInformation/facts/amr.jsp .

[27] It is possible for a business to be characterized as a pure operating company for tax purposes and a parent company for non-tax purposes. Under the Treasury's "check-the-box" regulations, a limited liability company that is wholly-owned by a corporation may be disregarded as a separate entity for tax purposes while retaining its separate legal personality for all other purposes. Treas. Reg. § 301.7701-2(c)(2)(i) (2009). This device has been used by some business groups to achieve a *de facto* consolidation while side-stepping requirements to comply with the consolidated return rules under tax law. *See* Mark J. Silverman & Lisa M. Zarlenga, *Use of Limited Liability Companies in Corporate Transactions*, 80 TAX NOTES 1469, 1486 (1998). Because of the 100% ownership requirement, though, it cannot substitute for a corporate pyramid.

[28] On the terminology, see BONBRIGHT & MEANS, *supra* note 22, at 10.

		pure holding companies.		support *etc*.
Corporate pyramid[29]	Yes	Yes.[30] The pyramidal structure presupposes there will be outside investors in companies below the top tier of the pyramid.	Unlikely, but possible.	Usually similar to "pure" holding companies.

With corporate pyramids, the corporation at the apex will likely resemble a holding company, in that it likely will do no more than provide marketing services, technical advice and general overall direction to lower-tier companies. This is by no means a hard and fast rule; the corporation at the apex could have a significant operating dimension, perhaps because the pyramidal structure developed after the corporation had achieved its own market niche. However, an intrinsic aspect of this type of business group is that the corporation will own shares in companies that have outside investors.[31] This is because it is outside investment that permits the family, entrepreneur or executives in charge to have corporate reach that exceeds their financial stake.

The corporation at the apex of a corporate pyramid should own enough shares in the publicly traded companies in the second tier of the pyramid to dictate the outcome of director

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[29] Morck categorizes a corporate organization with the features set out here as a "business group," but implicitly treats those qualifying as pyramids. *See* Morck, *Riddle*, *supra* note 6, at 1-2.

[30] For more detail on this point, see *infra* note 31 (discussion of Villalonga and Amit).

[31] In the literature on pyramids, it is widely assumed that the outside investors will be shareholders in a publicly traded company. *See* Belen Villalonga & Raphael Amit, *How are U.S. Family Firms Controlled?*, 22 REV. FIN STUD. 3047 (2009). The taxonomy in Table 1 reflects the consensus view. However, as Villalonga and Amit point out, so long as there are outside shareholders, a pyramid could be said to exist without the relevant companies being traded on a stock market. It is even arguable that there could be a pyramid with no outside shareholders at all, assuming that wholly owned subsidiary companies in a corporate group are highly leveraged. This would create what de Jong et al. call a "debt wedge," rather than the "equity wedge" traditionally associated with corporate pyramids, with creditors standing in for the role of public shareholders by providing debt financing. *See* Douglas V. DeJong, Abe De Jong, Gerard Mertens & Ulrich Hege, *Leverage in Pyramids: When Debt Leads to Higher Dividends* 3, 13 (Eur. Corp. Gov. Inst., Working Paper No. 261, 2009).

elections but will not necessarily need a 50% stake because many small shareholders will not vote.[32] The companies in the second layer of the pyramid can then hold blocks of the same nature in publicly traded companies in the third tier and so on. As Morck says, "Such pyramids could encompass hundreds of separate and listed and private firms and be more than a dozen layers deep."[33] Corporate pyramids correspondingly permit the leveraging of wealth sufficient to control one corporation into control over a group of companies worth far more.[34] As Adolf Berle and Gardiner Means suggested in their 1932 classic *The Modern Corporation & Private Property*, "The owner of a majority of the stock of the company at the apex of a pyramid can have almost as complete control of the entire property as sole owner even though his ownership interest is less than one percent of the whole."[35]

Berle and Means and Morck both use the business empire of two unmarried brothers, Oris Paxton Van Sweringen and Mantis James Van Sweringen, to illustrate a corporate pyramid in operation. The Van Sweringens, or the Vans for short, were real estate developers in Cleveland who first became involved with railways by purchasing in 1916 the Nickel Plate Road from the New York Central railway to secure railway access between downtown Cleveland and a planned suburb that became known as Shaker Heights.[36] As Saunders put it in his study of 20th century railway mergers, "A taste of big-time railroading whetted the Vans' appetite for more."[37]

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[32] Some researchers do argue that a stake of 50% is required for control but it is commonly assumed a smaller stake will suffice (e.g. 20%). On this point, see Morck, *Riddle*, *supra* note 6, at 2; Marc Levy, *Control in Pyramidal Structures*, 17 CORP. GOV. INT'L. REV. 77, 78-79, 81, 87 (2009).

[33] MORCK, *How to Eliminate*, *supra* note 5, at 136.

[34] Morck & Yeung, *supra* note 17, at 178.

[35] ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 69 (1932).

[36] FREDRICK LEWIS ALLEN, THE LORDS OF CREATION 294-95 (1935); Van Sweringen brothers – early developments, http://www.cleveland.com/shakerhts/index.ssf?/community/more/shakerhts/index.html.

[37] RICHARD SAUNDERS JR., MERGING LINES: AMERICAN RAILROADS 1900-1970 52 (2001).

The Vans relied on a holding company as the medium through which they ran their railway empire, in part because the Interstate Commerce Commission (ICC), the federal body in charge of regulating railways, was reticent to exercise jurisdiction over "pure" holding companies that owned shares in but did not directly operate railroads.[38] Throughout the 1920s the Van Sweringens acquired interests in additional railroads and when the ICC balked at consolidation plans the Vans had developed, they responded by forming a new holding company, the Alleghany Corporation, to connect their railway holdings.[39] According to Berle and Means, "By this pyramid an investment of less than twenty million dollars has been able to control eight Class I railroads having combined assets of over two billion dollars."[40]

While the Van Sweringens were able to rely on a pyramidal structure to build up a major railway empire and while corporate pyramids are commonplace around the globe, corporate pyramids are currently the exception to the rule in the United States. As Morck and Yeung have said "the United States has a highly exceptional corporate sector, almost devoid of pyramids….(T)he U.S. economy is basically made up of free-standing firms."[41] Morck observes similarly that "Finding anything approximating a business group in the United States is a painstaking labor."[42] This is something of an exaggeration. Masulis, Pham and Zein, in their multi-country empirical study, found more family business groups in the U.S. – 87 – than in any of the other 44 countries studied.

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[38] MARK H. ROSE, BRUCE E. SEELY & PAUL F. BARRETT , THE BEST TRANSPORTATION SYSTEM IN THE WORLD: RAILROADS, TRUCKS, AIRLINES, AND AMERICAN PUBLIC POLICY IN THE TWENTIETH CENTURY 25 (2006) [hereinafter ROSE ET AL.].

[39] *Id.* at 26; BONBRIGHT & MEANS, *supra* note 22, at 256, 259; SAUNDERS, *supra* note 37, at 64.

[40] BERLE & MEANS, *supra* note 35, at 69.

[41] Morck & Yeung, *supra* note 17, at 177; *see also* Morck, *Riddle*, *supra* note 6, at 3.

[42] MORCK, *How to Eliminate*, *supra* note 5, at 148.

On the other hand, according to Masulis, Pham and Zein, only 3.03% of U.S. public companies were part of family business groups and only 0.91% of all U.S. public companies were controlled through a pyramid structure. These percentages were the third and second lowest figures respectively among the countries Masulis, Pham and Zein examined.[43] Fellow economists Belen Villalonga and Raphael Amit report as well that while 5% of the 40% of Fortune 500 companies that are founder- or family-controlled (i.e. the family or founder owns 5% or more of the shares) use pyramids to help to ensure their control rights exceed their cash-flow rights, dual-class stock, disproportionate board representation and voting agreements are used much more commonly to achieve the same objective.[44] So, while corporate pyramids are not unknown in the U.S., this particular corporate structure is, in relative terms, rare.

While pyramids are currently the exception to the rule in the U.S., this purportedly has not always been the case. To quote Morck and Yeung again, "Before the mid-1930s…many U.S. companies were organized into control 'pyramids' – structures in which an ultimate owner controls a first tier of listed companies, each of which controls other listed companies, each of which controls yet more listed companies and so on."[45] Van Sweringen-style corporate empires thus seemingly were then norm. Matters then supposedly began to change dramatically, with corporate pyramids quickly fragmenting. But why? If corporate pyramids were once common in the U.S. and currently are common elsewhere, why are they now a rarity in the American corporate landscape?

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[43] Masulis et al., *supra* note 7, Table II. Gadhoum, Lang and Young report similarly that while pyramids are by no means unknown in the U.S., they are less common than in Europe or Asia. *See* Yoser Gadhoum, Larry Hsien Ping Lang & Leslie S.F. Young, *Who Controls US?*, 11 EUR. FIN. MGMT. 339, 347-48 (2005) (3.38% of US listed corporations "controlled" by pyramid using a 20% ownership threshold, as compared with 38.7% for Asia and 18.2% for Europe).

[44] Villalonga & Amit, *supra* note 31, at 3062-63, 3075-76.

[45] Morck & Yeung, *supra* note 17, at 174.

III. Intercorporate Taxation of Dividends and "The Riddle of the Great Pyramids"

A. In General

Morck purports to explain why corporate pyramids are rare in the U.S. but common elsewhere – his "Riddle of the Great Pyramids"[46] -- by reference to taxation. He argues that a radical simplification in corporate ownership structures began in the mid-1930s due in large measure to tax reform, particularly relating to the tax treatment of dividends received by corporations as stockholders. The imposition of tax on intercorporate dividends in 1935 reputedly made the corporate pyramidal structure impossible or at least unattractive from an economic perspective, leading existing pyramids to disband and dissuading the formation of new pyramidal structures. As Morck says:

> "(T)he United States intercorporate dividend tax was part of a carefully crafted and highly successful strategy in the 1930s aimed at rendering economically unviable certain corporate structures believed to facilitate governance problems, tax avoidance, market power, and dangerously concentrated political influence."[47]

The results, Morck maintains, were pretty much instantaneous. He claims that "By 1937, big American businesses were roughly as widely held and freestanding as now."[48]

The onset of the Depression dealt crippling blows to various complicated corporate empires and undermined the credibility of many of them.[49] For instance, a steep drop in stock prices in 1931 proved to be the death knell for the convoluted and highly leveraged business

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[46] Morck, *Riddle*, *supra* note 6.

[47] MORCK, *How to Eliminate*, *supra* note 5, at 136.

[48] Morck, *Riddle*, *supra* note 6, at 14.

[49] THOMAS P. HUGHES, NETWORKS OF POWER: ELECTRIFICATION IN WESTERN SOCIETY, 1880-1930 401 (1983); BENJAMIN GRAHAM, DAVID DODD, SIDNEY COTTLE & CHARLES TATHAM, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 604 (3d ed. 1951).

empire of utilities magnate Samuel Insull, wiping out Insull's personal fortune of $150 million together with the investments of 600,000 shareholders and 500,000 bondholders.[50] The sharp reversal of fortunes prompted a chorus of calls for reform.[51] Politicians were responsive, with President Franklin Roosevelt proclaiming in 1935 that utility holding companies had built up "a private socialism of concentrated private power"[52] and recommending the same year "the elimination of unnecessary holding companies in all lines of business…through taxation."[53] Correspondingly during the mid-1930s a number of changes were made to federal tax law to "strike at the holding company system."[54] One was to tax intercorporate dividends, the change Morck says "was largely responsible for producing the country's highly exceptional corporate sector composed of free-standing widely held firms."[55] Some background on taxation of dividends helps to put this claim into perspective.

U.S. tax law subjects dividend income to "double taxation", with tax being levied first against the corporation when it earns the income and a second time against the shareholder when the shareholder receives the income as a dividend. In the U.S., there is typically some element of double taxation regardless of whether the shareholder is an individual or a corporation. This is not the case in most countries where there is double taxation of dividends. Dividends are subject to taxation at both the corporate and shareholder levels, but there are no additional layers of taxation when dividend income travels up the corporate chain. Instead, dividends are fully

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[50] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 22 (Houghton Mifflin 1982).

[51] *See*, *e.g.*, John J. Flynn, *Pyramiding of Holding Companies*, 159 ANNALS AM. ACAD. POL. & SOC. SCI. 15, 19-22 (1932); *Holding Company Magic*, ATLANTA CONST., Dec. 20, 1931, at 14A; WILLIAM E. MOSHER, PUBLIC UTILITY REGULATION 360-65 (1933).

[52] *Roosevelt Calls for End of Utility Holding Companies*, N.Y. TIMES, Mar. 13, 1935, at 1.

[53] *Tax Penalty Eased for Holding Firms*, N.Y. TIMES, Aug. 29, 1935, at 6.

[54] *Tax Bill Changes Offered by Borah*, N.Y. TIMES, Mar. 2, 1934, at 38.

[55] MORCK, *How to Eliminate*, *supra* note 5, at 168.

deductible when the recipient is a corporation, as long as the corporation receiving the dividend owns a prescribed minimum percentage of shares of the corporation paying the dividend. In Canada, for instance, the dispensation is available so long as the ownership stake is 10% or more.[56]

The path the U.S. took in departing from the global norm concerning the taxation of intercorporate dividends was somewhat circuitous. Under the first post-Sixteenth Amendment income tax adopted in 1913, intercorporate dividends were subject to full taxation. While unpopular, corporations evidently took this aspect of corporate tax largely in stride. As Edwin Seligman concluded in a report for the American Economic Association's Committee on War Finances, "this was possible, although unjustifiable, when the rate of the income tax was only 1 or 2 per cent."[57]

By 1917 the corporate income tax rate had tripled from 2% to 6%. This increase in rates, coupled with a 1916 tax of fifty cents per $1,000 of capital stock that resulted in double, triple, or even quadruple taxation for corporate groups, spurred some companies to consider unwinding their holding company structures.[58] In 1917 Congress sought to alleviate the double tax burden for intercorporate dividends by creating a tax credit that provided a corporate stockholder receiving a dividend with a partial rebate against the tax due.[59] The *Wall Street Journal* said the

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[56] *Id.* at 145.

[57] *Seligman Reports on War Finances*, N.Y. TIMES, Dec. 28, 1918, at 14 [hereinafter *Seligman Reports*].

[58] One such group – the Distillers Securities Corporation – even announced that it planned to merge all of its subsidiaries with the parent corporation to avoid the tax. *New Taxation to Spur Corporate Reorganization*, WALL ST. J., Oct. 21, 1916, at 5.

[59] War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917), § 4, stipulating "the income embraced in a return of a corporation . . . shall be credited with the amount received as dividends upon the stock or from the net earnings of any other corporation . . . which is taxable upon its net income provided in this title." The 1917 Act's relief provision was incomplete because it only created a credit for a four percent levy created earlier that year. A 2% levy introduced in 1916 remained in place, meaning that a corporation would pay a 6% combined normal tax on all

1917 reform, "commendable as it was, did not go far enough and resulted in much confusion."[60] In response, Congress adopted in 1918 what Seligman called a "simple justice by permitting corporations to deduct from their taxable income the whole amount of such dividends" received from subsidiary corporations.[61] This matched the current pattern in Canada and other countries.[62]

Matters changed again in 1935, when the full deduction was replaced by a large (90%) but nevertheless partial deduction, which was lowered to 85% in 1936. This resulted in an effective tax rate of 2.25% on dividends received by corporate stockholders, given the prevailing rate of taxation on corporate income of 15% on income in excess of $40,000.[63] A similar regime remains in place today, although the proportion of dividends exempted from tax now depends upon the size of the ownership stake in the corporation distributing the dividend.[64] All dividends are exempted if the corporation receiving the dividends has an ownership stake of greater than 80%. 80% of dividends are excluded in the case of corporations in which the ownership stake is less than 80% and greater than 20% and the exemption falls to 70% if the stake is smaller than 20%. Thus, based on the prevailing income tax rate of 35%, the effective rate of taxation on dividends is 10.5% if the corporation receiving the dividends owns up to 20% of the shares of the corporation paying the dividend. The rate is 7% if the stake is between 20% and 80% and is zero if the stake is 80% or more.

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dividends received from its subsidiaries, receive a credit for the four percent element of the tax and still pay double taxation on the 2% levy.

[60] *Justice to Corporations Begins to Appear*, WALL ST. J., May 14, 1918, at 10.

[61] *Seligman Reports*, *supra* note 57.

[62] MORCK, *How to Eliminate*, *supra* note 5, at 149.

[63] For historical corporate tax rates and thresholds, see TAX POLICY CENTER, HISTORICAL CORPORATE TOP TAX RATE AND BRACKET (2008), http://www.taxpolicycenter.org/taxfacts/Content/PDF/corporate_historical_bracket.pdf.

[64] I.R.C. § 243 (1996).

The tax on intercorporate dividends in the mid-1930s was introduced partly as a corollary to the simultaneous introduction of a graduated marginal rate structure for corporate income tax, with the idea being to deter those minded to evade higher rates by splitting a corporation into several companies to reduce the size of each firm's income.[65] However, the change was also widely understood to be part of an attack on corporate holding companies and Morck argues that the new tax was intended to make it less attractive to operate in pyramidal form. As he says, "Intercorporate dividends taxation was introduced in the United States in 1935 with the explicit objective of breaking up pyramidal groups."[66]

The Temporary National Economic Committee (TNEC), established jointly in 1938 by Congress and the President to investigate the concentration of economic power in the U.S., suggested that taxation of incorporate dividends was in fact little more than a side-show. The TNEC, in a 1941 report on corporate taxation, said that intercorporate dividend taxation was only "a mild deterrent to holding companies and related forms of affiliated corporations" and its effect had "on the whole been rather negligible."[67] Nevertheless, the theory that the introduction of intercorporate taxation of dividends prompted corporate pyramids to unwind is becoming received wisdom.

Law professor Mark Roe argued in his 1994 book *Strong Managers, Weak Owners* that the introduction of double taxation of intercorporate dividends deterred companies from holding large ownership blocks in other companies, reasoning that only rarely would returns from such

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[65] TEMPORARY NATIONAL ECONOMIC COMMITTEE, TAXATION OF CORPORATE ENTERPRISE 59 (1941).

[66] MORCK, *How to Eliminate*, *supra* note 5, at 152.

[67] TEMPORARY NATIONAL ECONOMIC COMMITTEE, *supra* note 65, at 59, 63.

an investment be sufficient to compensate for the tax penalty on dividends paid out.[68] More recently, economists Tarun Khanna and Yishay Yafeh specifically endorsed Morck's work in a 2007 survey of the literature on corporate pyramids, indicating "diversified American groups were common through the mid-1930s" and, referring to the introduction of intercorporate taxation of dividends in 1935, claimed that "only a unique historical event prevent(ed) the existence of business groups in the United States as well".[69] Villalonga and Amit concur, saying in a 2009 paper their finding that pyramids are rarely used by present day founder- and family-controlled firms in the Fortune 500 is consistent with Morck's argument "that pyramidal business groups largely disappeared from the United States in the 1930s as a result of intercorporate dividend taxation and other tax reforms that rendered them prohibitively costly."[70]

B. The Twentieth Century Fund's Study of Tax Reform

While the argument that the introduction of intercorporate taxation of dividends prompted the demise of the corporate pyramid in the U.S. is now close to conventional wisdom, to date the only empirical evidence on point is Morck's analysis of a 1937 study conducted by the Twentieth Century Fund on tax reforms instituted during the New Deal. Simplification of complex corporate structures was something of a trend in the 1930s,[71] and the Twentieth Century Fund in its tax study identified 30 major U.S. corporations that had recently eliminated holding

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[68] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 107-8 (1994).

[69] Khanna & Yafeh, *supra* note 11, at 341.

[70] Villalonga & Amit, *supra* note 31, at 3075.

[71] *Holding Companies Turn to Operating*, N.Y. TIMES, Jan. 12, 1936, at F1 ("The conversion of many American industrial holding companies into operating units, through liquidation of subsidiaries, has been gaining momentum steadily….") [hereinafter *Holding Companies*].

company structures.[72] Morck argues the corporate restructuring carried out by the 30 firms constituted evidence of "the rapid dissolution of the pyramidal groups in the United States."[73]

In fact, the Twentieth Century Fund study provides little direct guidance on a possible connection between tax reform and the dismantling of pyramidal structures. Specifically, the study did not indicate whether the 30 firms it identified as having eliminated holding company arrangements were at the apex of corporate pyramids and said only a few of the companies had expressly mentioned that new tax laws had prompted a reorganization. Morck acknowledged the latter point when he summarized the Twentieth Century Fund's findings in tabular form, indicating that the introduction of the intercorporate taxation of dividends was only "Explicitly cited as justification" for reorganization by six of the companies (Bethlehem Steel Corp., Borden Co., Diamond Match Company, E.I. du Pont de Nemours Co., International Hydro-Electric System Co. and U.S. Rubber).[74] For the remaining 24, he said there was "Apparent tax saving, but not explicit mention."[75]

We investigated further by analyzing for the 30 companies reports in *Moody's* trade manuals, newspaper stories available on the ProQuest Historical Newspaper Database and annual reports to shareholders available on ProQuest or in UCLA's Rosenfeld Library Collection of Annual Reports to Shareholders. Our follow up research revealed that only seven of the 30 companies cited by the Twentieth Century Fund study were part of a pyramidal structure (see Table 1). Two of the companies, Atlas Corporation and Electric Bond and Share Company, constituted the top tier of a corporate pyramid, in the sense they held partial stakes in a

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[72] MORCK, *How to Eliminate*, *supra* note 5, at 153.

[73] *Id.*

[74] *Id.* at 154 (Table 3).

[75] *Id.*

significant number of publicly-traded subsidiaries and lacked a dominant corporate shareholder.[76] The five other companies, Central Power and Light, Central Maine Power, Electric Power and Light, International Hydro-Electric and Northern New York Utilities, also belong in the pyramid category because they were affiliated with utility pyramids focused around Samuel Insull's utilities empire, the Electric Bond and Share group, International Paper and Power Co. and the United Corporation Group, respectively.

Table 1: Company Reorganizations Cited by Twentieth Century Fund Tax Study Where the Company Was Part of a Pyramidal Structure

Company	**Type of Corporate Structure**	**Type of Business**	**Cites Inter-corporate Dividends Tax?**	**Other Tax Provisions Cited**	**PUHCA Cited?**[77]	**Consolidation Begun**
Atlas Corp.	Pyramid	Investment/ Financial		"Earnings…will accrue directly without intervening taxes."[78]		1932
Central Maine Power Company	Pyramid (holding company in the Insull utilities pyramid)	Utility			Yes	Early and mid 1935
Central Power and Light Co.	Pyramid (parent company in Insull utilities pyramid)	Utility				1935
Electric Bond and Share	Pyramid	Utility			Yes	1935
Electric Power and	Pyramid (holding,	Utility			Yes	1930

[76] MOODY'S CORP., BANK AND FINANCE MANUAL 2009 (1935) (Atlas Corporation); MOODY'S CORP., PUBLIC UTILITY MANUAL 1405 (1935); *infra* notes 144-45 and accompanying text (Electric Bond and Share). General Electric was the creator and at one point dominant shareholder of Electric Bond and Share, but that relationship ended in 1924 when G.E. spun-off Electric Bond and Share. *See* BONBRIGHT & MEANS, *supra* note 22, at 106.

[77] In some cases, consolidation began for unrelated reasons prior to 1935, but the company cited PUHCA in 1935 or 1936 as either an additional justification for continuing its consolidation program or as a reason to increase the pace of consolidation activity.

[78] *Atlas Corp. Proposes Final Step to Complete Consolidation Plan*, WALL ST. J., Sept. 29, 1936, at 3 [hereinafter *Atlas Corp. Proposes*].

Light	company in Electric Bond and Share pyramid)					
International Hydro-Electric System	Pyramid (holding company in Int'l Paper and Power pyramid)[79]	Utility			Yes	1935
Northern New York Utilities	Pyramid (holding company in United Corp. pyramid)[80]	Utility				1935-1936

Sources: Moody's Public Utilities Manual; Moody's Banking and Finance Manual; Moody's Manual of Investments; Various Shareholder Reports; Bonbright and Means, *The Holding Company*.

As Table 2 indicates, among the remaining twenty three firms six were parent companies, reflecting the fact they owned subsidiary companies but also had a substantial operating dimension. Seventeen were pure holding companies, as they lacked an operating aspect. These seventeen were not part of a pyramidal structure because their domestic subsidiary companies were rarely (if ever) partially owned and publicly-traded.

Table 2: Company Reorganizations Cited by Twentieth Century Fund Tax Study Where the Company Was Not Part of a Pyramidal Structure

[79] International Hydro-Electric is not identified specifically in secondary sources as a pyramid. However, this classification is appropriate given that its parent company, International Power and Paper, held a 68% stake in International Hydro-Electric, given the remainder was publicly traded and given that International Hydro-Electric had publicly traded subsidiaries. On International Power's stake in International Hydro-Electric, see *Voting Trust Aids Utility Separation*, N.Y. TIMES, Dec. 8, 1935, at F1.

[80] Northern New York Utilities, Inc. was intended to be the survivor of the consolidation of the holding company Niagara Hudson Power Corporation and its operating subsidiaries, including Northern New York Utilities, which was the only publicly-traded company in the group. *See Stockholders Back Merger of Utility*, N.Y. TIMES, Jan. 22, 1936, at 31[hereinafter *Stockholders Back Merger*]. The New York Public Service Commission, however, refused the group's application for the merger. *See Merger Plan Withdrawn*, N.Y. TIMES, Aug. 15, 1936, at 20. Several other holding company subsidiaries of Niagara Hudson were dissolved or merged into Niagara Hudson in 1935.

Company	Type of Corporate Structure	Type of Business	Cites Inter-corporate Dividends Tax?	Other Tax Provisions Cited	PUHCA Cited?[81]	Consolidation Begun
A. G. Spalding	Parent	Industrial		Consolidated return repeal		Late 1934
Acme Steel Co.	Holding	Industrial		Undistributed profits tax		January 1936
Air Reduction Co.	Holding	Industrial				August 1937
Associated Gas and Electric Co.	Holding	Utility		Consolidated return repeal	Yes	1922
Atlas Powder Co.	Holding	Industrial				August 1933 and June 1934
Bethlehem Steel	Holding	Industrial	Yes[82]			February 1936
Blackstone Valley Gas and Electric	Holding	Utility				1935
Borden Co.	Holding	Industrial		"Revenue Act of 1935"		January 1936
Consolidated Oil Corp.	Holding	Industrial				1934
Diamond Match	Holding	Industrial	Yes[83]	Match industry-specific taxes; graduated corporate tax; undistributed profits tax		1936
DuPont de Nemours and Co.	Parent	Industrial	Yes[84]	Consolidated return repeal; undistributed profits tax		1936
Eastern Gas and Fuel Assoc.	Holding	Utility			Yes	1934, 1936
Eastman Kodak Co.	Holding	Industrial		"Recent tax legislation"		1936
General	Holding	Industrial	Yes[85]	Graduated		1935, 1936

[81] In some cases, consolidation began for unrelated reasons prior to 1935, but the company cited PUHCA in 1935 or 1936 as either an additional justification for continuing its consolidation program or as a reason to increase the pace ofconsolidation activity.

[82] *Bethlehem Steel's Unification Plans Are Approved*, WALL ST. J., Feb. 27, 1936, at 8.

[83] DIAMOND MATCH CO., REPORT TO STOCKHOLDERS OF THE DIAMOND MATCH COMPANY FOR THE YEAR 1935 177-78 (1936).

[84] *Du Pont Merges Unit to Cut Levy Under Tax Bill*, WALL ST. J., July 2, 1936, at 1; DU PONT DE NEMOURS & CO., ANNUAL REPORT FOR 1935 12 (1936).

[85] General Foods, however, did not make any attempt to connect the tax with the reorganization. In the "Taxes" section of its 1936 shareholder report, the company stated "substantial changes made by the Revenue Act of 1936 included new levies either immediately or potentially affecting General Foods Corporation and its stockholders, as

Foods				corporate tax; undistributed profits tax		
International Harvester	Holding	Industrial				1936
McKesson and Robbins, Inc.	Holding	Industrial		Graduated corporate tax		October 1934
Nevada-California Electric Corp.	Holding	Utility			Yes	1935-1936
Pacific Gas and Electric	Parent	Utility				1931
Pillsbury Flour Mills Co.	Holding	Industrial				1935
Safeway Stores	Parent	Industrial		Chain store taxes		1936
Southern Pacific Company	Parent	Railroad				1932
Union Pacific Railroad	Parent	Railroad				1935
United States Rubber Co.	Holding	Industrial		Revenue Act of 1935; Consolidated return repeal		1934

Sources: Moody's Public Utilities Manual; Moody's Banking and Finance Manual; Moody's Manual of Investments; Various Shareholder Reports; Bonbright and Means, *The Holding Company*.

Among the seven companies cited in the Twentieth Century Fund study that were part of a pyramidal structure none specifically cited the introduction of the intercorporate taxation of dividends as a catalyst for consolidation (Table 1). In the case of Atlas, during the early 1930s it acquired dominant stakes in nearly 25 investment companies trading at distressed prices due to the stock market crash and promptly sought to simplify the overall capital structure by absorbing

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follows: (1) the 4% normal tax upon dividends received by stockholders; (2) an income tax at an effective rate of 2.25% upon intercompany and other dividends received by the corporation; (3) the undistributed profits tax applicable to the corporation; and (4) the so-called 'windfall tax' applicable to subsidiary processors of agricultural commodities formerly subject to processing taxes." *See* GENERAL FOODS CORP., 1936 ANNUAL REPORT 7-8 (1937). In the "Corporate changes" section, though, the company refrained from mentioning tax as a catalyst for consolidation, saying instead that "in order to simplify corporate structure and effect economies, assets and operations formerly owned and conducted by certain manufacturing subsidiaries were transferred in liquidation to the parent company during the year without change in factory locations." *Id.* at 8.

the acquired firms.[86] The consolidation process was complete by 1936.[87] Electric Power and Light began its own consolidation program in 1930, well before the tax changes.

Otherwise, consolidation of companies in the pyramid category was apparently due to the enactment of the Public Utility Holding Company Act of 1935 (PUHCA),[88] a legislative measure designed to simplify the corporate structure of the utilities industry. Electric Bond and Share responded to enactment of the legislation by reducing its holdings in all utility companies below a 5% "affiliate" threshold in the legislation, save for six former "client" holding companies where it resisted making changes.[89] In late 1935 the International Hydro Electric system indicated it was relinquishing control of the $400 million New England Power Association to try to obtain an exemption from full-scale regulation under the PUHCA and, when in 1939 International Paper and Power, International Hydro-Electric's parent company, transferred its utilities properties to a liquidating trust, SEC chairman William O. Douglas hailed the arrangement as a precedent for other utility companies subject to PUHCA to follow."[90] Similarly, when Central Maine Power transferred all of the properties of its subsidiaries to itself in October 1935 it became a pure operating company and thereby avoided Public Utility Holding

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[86] *Atlas Securities Would Merge Units*, N.Y, TIMES, June 10, 1932, at 29; *Atlas Expansion Near Completion*, WALL ST. J., June 11, 1932, at 7.

[87] *Atlas to Absorb Rest of Affiliates*, N.Y. TIMES, Sept. 29, 1936, at 41; *Atlas Corp. Proposes, supra* note 78, at 3.

[88] 49 Stat. 803.

[89] *Investments Cut by Bond and Share*, N.Y. TIMES, Dec. 6, 1935, at 39. Subsequent PUHCA-mandated consolidation was postponed due to legal challenges. See *Company Reports Subsidiaries Out*, N.Y. TIMES, Sept. 5, 1950, at 45. The reorganization process with Electric Power and Light was similarly protracted. *Hearing on Utility Is Begun in Court*, N.Y. TIMES, Apr. 13, 1949, at 47.

[90] *See Utility Act Forces a Huge Divestment*, N.Y. TIMES, Dec. 2, 1935, at 31; *Paper Company to Sell Utilities*, N.Y. TIMES, Feb. 1, 1939, at 33. International Paper and Power did engage in a recapitalization to respond to tax concerns, but these concerns were prompted by a tax on undistributed profits introduced in 1936 rather than the intercorporate dividends tax, and the recapitalization did not involve International Hydro-Electric. *New Capital Plan in View for Utility*, N.Y. TIMES, Sept. 22, 1936, at 49.

Company status.[91] Finally, while Central Power and Light's and Northern New York Utilities' consolidations were ostensibly motivated by efficiency concerns,[92] the timing and nature of their consolidation activity suggest that they too may have been influenced by the PUHCA.

While none of the 30 companies dealt with in the Twentieth Century Fund study that were pyramidal in orientation specifically cited intercorporate taxation of dividends as a reason for consolidation we found among four of the other 23 companies evidence indicating the tax change did indeed help to prompt corporate consolidation. Three of the companies were among the six Morck's put in his "Explicitly cited as a justification" category (Bethlehem Steel, Diamond Match, and Du Pont). In addition, General Foods, a company in Morck's "Apparent tax saving, but not explicit mention" category, specifically mentioned that the introduction of intercorporate taxation of dividends could affect the company but did not attribute its reorganization decision to tax reform.

Why was intercorporate taxation of dividends mentioned by these companies as an inducement to consolidate when they were not part of a corporate pyramid? The likely reason was that the tax, as originally introduced, provided incentives for consolidation of corporate groups oriented around wholly-owned subsidiaries as well as for unwinding pyramidal structures. At present, intercorporate taxation of dividends does not put parent companies under an onus to consolidate subsidiaries because a full deduction is available when a company owns 80% or more of the shares of the company paying the dividend. However, when the tax was first

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[91] *Central Maine Power Classified as Strictly Operating Unit Now*, WALL ST. J., Oct. 4, 1935, at 6.

[92] For Central Power and Light, the two subsidiaries dissolved during 1935 had either leased out or distributed their properties during the year. *See* MOODY'S CORP., MANUAL OF INVESTMENTS, AMERICAN AND FOREIGN 638 (1937). For Northern New York Utilities, its application with the New York Public Service Commission described "the elimination of the necessity for maintaining such separate records and the economies in operation by the consolidated company." *Stockholders Back Merger, supra* note 80, at 31.

introduced it applied even to wholly owned subsidiaries.[93] As a result, the tax put holding companies at a disadvantage compared to simple operating companies and created an incentive to dissolve subsidiaries and transfer the underlying assets to the parent company.[94]

Among the three remaining companies in Morck's "Explicitly cited tax as a justification" category (Borden, International Hydro-Electric and United States Rubber), two (Borden and U.S. Rubber) cited the Revenue Act of 1935 and recent tax legislation generally to explain their corporate reorganization plans, but did not single out the taxation of dividends specifically as a justification for consolidation. Our research indicates Borden and U.S. Rubber were by no means alone in drawing attention to tax reforms other than intercorporate taxation of dividends as an incentive for consolidation. Nine additional companies in Table 2, when giving reasons for corporate stream-lining, cited a number of additional tax changes introduced at much the same time.

As Table 3 indicates, various mid-1930s tax reforms did in fact provide incentives for corporate groups to consolidate. Morck claims these changes augmented the incentives the intercorporate taxation of dividends provided to unravel corporate pyramids, observing "This mix of carrots and sticks created tremendous pressure of (*sic*) pyramidal groups to restructure into one or more freestanding companies."[95] However, as Table 3 also spells out, these changes were irrelevant for corporate pyramids or at least provided no special incentive to unwind existing arrangements. Correspondingly, while Morck relies on the list of 30 companies the

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[93] See TAX POLICY CENTER, *supra* note 63, and accompanying text.

[94] *U.S. Steel Program Seen as Tax Saver*, N.Y. TIMES, Sept. 22, 1935, at F1 [hereinafter *U.S. Steel*]; *Holding Companies*, *supra* note 71; *Bethlehem Steel to Realign Set-Up*, N.Y. TIMES, Jan. 17, 1936, at 27. *See also* Roswell Magill, *Effect of Taxation on Corporate Policies*, 72 U.S. L. REV. 637, 642 (1938) ("The effect of this additional tax must have been to reduce materially the number of holding companies and also to reduce the number of subsidiaries set up to operate particular branches of the business.").

[95] Morck, *Riddle*, *supra* note 6, at 14.

Twentieth Century Fund compiled in its 1937 study to support his claim that tax reform prompted the rapid dismantling of corporate pyramids, in fact the experience of these 30 companies provides little empirical support for the arguments he advances.

Table 3: Other Tax Provisions Prompting Consolidation

Tax Provision	**Date and Nature of Change**	**Incentive to Consolidate**	**Applicability to Pyramids**
Repeal of consolidated returns	Starting in 1934, most corporations were no longer permitted to file one return that combined the income and losses from all of its affiliated subsidiaries.[96]	In order to use the losses from one business to offset the income from another, corporate groups had to merge their subsidiaries into one corporation.[97]	Consolidated returns were only available to companies and their 95% owned subsidiaries, which excluded the typical pyramidal group.
Graduated corporate rates	Starting in 1936, Congress subjected corporations to progressive marginal rates based on income. Rates ranged from 8% on income up to $2,000 to 15% on income above $40,000.	Corporations with both income and loss producing subsidiaries may have been moved to combine them to avoid the higher rates, especially in the absence of consolidated returns. For corporate groups with primarily income-producing divisions, there may have been an incentive to increase the use of	Likely affected pyramids the same as other corporate structures.

[96] From 1932 to 1934, companies paid high rates of corporate tax for the privilege of filing a consolidated return and in 1934 this option was denied to all companies except railway corporations. *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1164, n. 13 (2004) [hereinafter Bank, *Tax*]. The rules precluding the use of consolidated returns were reversed partially in 1940 and then completely in 1942: *See* George Mundstock, *Taxation of Intercorporate Dividends Under an Unintegrated Regime*, 44 TAX L. REV. 1, 10 (1988). The 1942 change, though, effectively introduced a 100% exclusion for intercorporate dividends in companies filing a consolidated return. *Id.* at 11.

[97] *Holding Companies*, *supra* note 71; *Bethlehem Steel to Realign Set-Up*, *supra* note 94; *U.S. Steel*, *supra* note 94; Godfrey N. Nelson, *New Taxes Tend to Speed Mergers*, N.Y. TIMES, July 19, 1936, at F1. The ability to offset profits and losses became potentially even more important in 1933 after Congress barred companies from applying a current year's net operating losses to future years' profits in order to reduce tax liability. SUBCOMM. OF H. COMM. ON WAYS & MEANS, 93D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 10 (Comm. Print 1933). The carry-forward of net operating losses was prohibited under the National Industrial Recovery Act of 1933 because of concerns, highlighted during the Pecora Hearings on the causes of the Depression, that wealthy individuals and businesses were able to avoid taxes entirely due to a surplus of losses realized during 1929 and 1930. *See* Bank, *Tax*, *supra* note 96, at 1175-78.

		subsidiaries.	
Tax-free liquidations of controlled subsidiaries	Prior to 1935, corporations that liquidated a subsidiary by merging it into the parent corporation incurred capital gains tax on any appreciation.[98] In 1935, Congress permitted such liquidations to occur without tax. Tax on any profit was deferred until a subsequent sale of the former subsidiary's assets.	The change to the law facilitated reorganizations that may have been inhibited by the potential for taxation of capital gains.[99]	To qualify as a controlled subsidiary and be eligible for tax-free liquidation, a parent company had to own at least 80% of the shares of the company being liquidated. This excluded most pyramidal groups.
Undistributed profits tax	This tax, enacted in 1936, imposed a charge on a corporation's undistributed net income at rates ranging from 7% to 27%.[100]	Since the tax applied to each individual corporate subsidiary, consolidation potentially reduced a group's exposure.	Likely affected pyramids the same as other corporate structures.

Sources: Cited in footnotes.

IV. The Impact of Intercorporate Taxation of Dividends – An Empirical Test

While developments concerning the 30 companies cited in the Twentieth Century Fund's 1937 study of taxation fail to provide strong support for the proposition that the introduction of taxation of intercorporate dividends prompted the unwinding of corporate pyramids, the small sample size means that it is inappropriate to draw strong inferences. Correspondingly, we undertake a more broadly based empirical test. The received wisdom concerning the introduction of intercorporate taxation of dividends and corporate pyramids can be framed as a

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[98] MORCK, *How To Eliminate*, *supra* note 5, at 152.

[99] Indeed, the provision was in part designed to facilitate reorganizations required by the enactment of the Public Utility Holding Company Act in 1935: Magill, "Effect of Taxation," at 641. The provision also may have been prompted by the desire to help corporate groups reorganize after the repeal of the consolidated return. *See* Norris Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907, 926 (1941).

[100] Revenue Act of 1936, Pub. L. No. 74-740, § 14(b), 49 Stat. 1648, 1655 (1936).

testable hypothesis: Corporate stockholding in publicly traded companies should have declined significantly after the tax on intercorporate dividends was introduced. To test this hypothesis on a firm-level basis, we relied on data corporations were obliged to file in accordance with section 16(a) of the Securities and Exchange Act of 1934 to compile a hand-collected data set of corporate stockholders and the size of their holdings extending from the beginning of 1936 to the end of 1938.

Under section 16(a), as originally enacted, an owner of 10% or more of the shares in a corporation registered on a national securities exchange was required to report the holding to the Securities and Exchange Commission, as were the directors and officers of such a firm. Any changes in such ownership thereafter also had to be reported. This disclosure requirement remains in place today, with the disclosure threshold being reduced to 5% in the mid-1970s.[101]

Filings by shareholders owning 10% or more of a company's stock are publicly available back to the end of 1935, with relevant subsequent changes being reported on a month-by-month basis. In compiling our data set we used as our departure point a 1936 volume the SEC prepared which detailed for the 1736 corporations registered with it as of the end of 1935 shareholdings exceeding 10% as well as all shareholdings of directors and officers. According to the SEC statement accompanying the release of this volume, these "insiders" collectively owned approximately 21% of all shares, and corporations were the most important category of insider, holding more than half of the total number of insider shares reported, which accounted for nearly 14% of all public shares outstanding.[102]

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[101] Securities and Exchange Commission Release Notice, Release No. 33-5609, Release No. 34-11616, Release No. 35-19140 (Aug. 25, 1975) (proposing an amendment dropping the threshold to 5%); Robert D. Hershey, *S.E.C. Is Tightening Rule on Disclosing Big Stockholders*, N.Y. TIMES, Feb. 25, 1977, at 73.

[102] Securities Exchange Act Release No. 989, ¶3, at 4 (Dec. 26, 1936).

Of the 1736 issuers registered with the SEC as of the end of 1935, 331 (18.9%) had a corporate shareholder owning 10% or more of the common shares. There were 427 instances in total where a corporation was a holder of 10% or more of common stock.[103] A cohort of 261 corporations owned these 427 stakes. 72 of the 427 holdings (16.9%) involved companies falling within the scope of Public Utilities Holding Company Act of 1935. 293 (68.6%) related to issuers in the non-PUHCA category and 62 (14.5%) of the companies could not be categorized satisfactorily. Utilities were over-represented among this cohort, at least in comparison to public companies generally, as only 7% of the 1,273 companies traded on the New York Stock Exchange as of 1930 were from the utilities sector.[104]

From this departure point we reviewed for each month during 1936, 1937 and 1938 changes in holdings of common stock by corporations owning 10% or more of the shares of a company registered with the SEC. In so doing we introduced into our dataset any new instances of corporations owning stakes of 10% or more, though there were very few of these. We then grouped the changes into increases, decreases, and sell-outs, with the latter being a subset of the "decreases" category.

Our study is the first to use S.E.C. filings by major shareholders to ascertain historically the extent to which corporations held sizeable stakes in U.S. public companies.[105] This likely is due to the fact that ascertaining changes in share ownership by reference to S.E.C. data is a laborious process. One might have anticipated that with the disclosures corporations made as of

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[103] The total was higher once preferred shares were taken into account. According to the SEC's analysis of the data, there were 873 instances where a corporation was a 10+% holder of all shares of stock, both common and preferred. *See* FRANK P. SMITH, MANAGEMENT TRADING: STOCK MARKET PRICES AND PROFITS 73, Table II (1941) (abstracting data from Table I of the materials prepared to support Securities Exchange Act Release No. 989).

[104] Mary O'Sullivan, The *Expansion of the U.S. Stock Market: Historical Facts and Theoretical Fashions*, 8 ENTERPRISE & SOC'Y 489, 499 (2007).

[105] *See* Michael J. Barclay, Clifford G. Holderness & Dennis P. Sheehan, *Dividends and Corporate Shareholders*, 22 REV. FIN. STUD. 2423, 2437 (2009) (indicating their study, based on 1995 data, offered the first reported data on the extent of corporate blockholding in U.S. public companies) [hereinafter Barclay et al.].

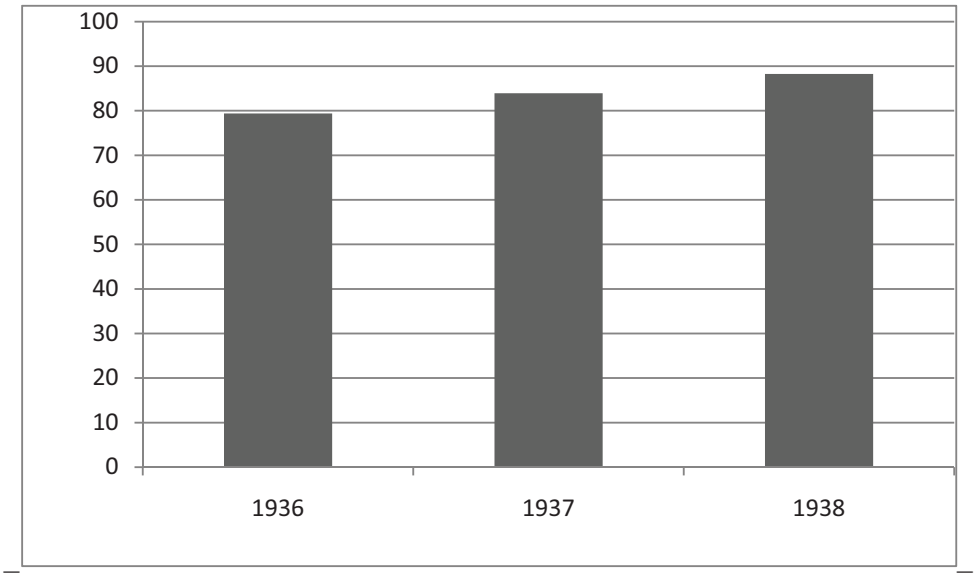
year-end 1935 when they held stakes of 10% or more they would have divulged the percentage of shares owned and that with subsequent filings they would have indicated the magnitude of the size of the change. Matters, however, were not so simple. Instead, the 1936 SEC volume we used as our departure point disclosed nothing more than the number of shares a corporation owned as of year-end 1935 and subsequent monthly filings at the time of an acquisition or disposition of shares only disclosed the number of shares acquired or disposed of in that month. This meant that to calculate the percentage change in each holding, we had to collect data month-by-month and extrapolate backwards to the data the SEC complied for its 1936 report on the total number of shares corporate stockholders owned and had to rely Moody's manuals to determine the total number of shares issued by the corporations registered with the S.E.C.

Due to the labor-intensive nature of our searches, we were only in a position to investigate changes occurring up to the end of 1938. It is possible that unwinding of corporate stakes induced by the introduction of taxation of intercorporate dividends occurred in 1939 and thereafter as a result of intertia or transactions costs. However, Morck says the dissolution of corporate pyramids was "rapid", and our data does address this claim. To the extent Morck is correct, corporations with stakes of 10% or more in companies registered with the SEC should on numerous occasions have sold out completely or at least reduced their holdings substantially. A sizeable proportion of companies might well have maintained their shareholdings during the period we consider. Increases, however, should have been extremely rare.

Our results indicate a rather different pattern. The unwinding of stakes held by corporations was most pronounced in 1936, which implies there was some short-term reaction to tax reform. However, in all three years covered by our study, by far the most common scenario was the status quo. As Figure 1 indicates, 79.4% of corporate-held stakes of 10% or more

remained unchanged in 1936. This status quo figure increased to 84% in 1937 and 88.3% in 1938. The status quo proportion was above 80% in all years for non-PUHCA companies and PUHCA companies. It was in the non-classified group that there was the most action, with the status quo proportion being 58% in 1936, 70.5% in 1937 and 71.4% in 1938.

Figure 1: Percentage of Corporate Shareholdings Unchanged, 1936-1938

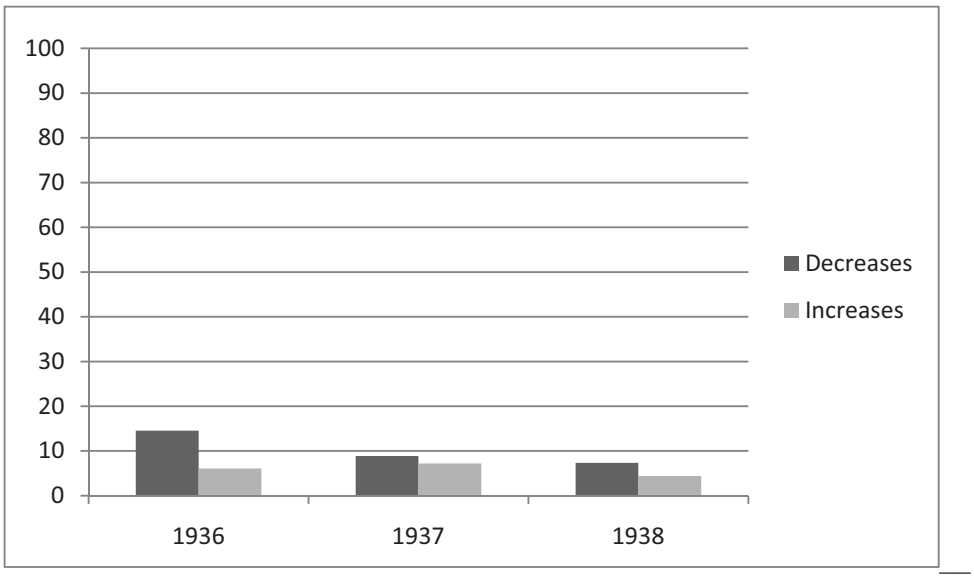


Source: Compiled from S.E.C. filings.

As for those instances where there was a change in the size of the stakes corporations held in publicly traded firms, our findings indicate, as anticipated, decreases outnumbered increases. However, there were numerous instances where corporate stockholders accumulated additional shares and, as Figure 2 illustrates, the discrepancy between the decreases and the increases was not as large as the received wisdom on intercorporate taxation of dividends would suggest. In 1936, the decrease vs. increase figures were 14.5% and 6.1% respectively, a ratio of 2.38:1, and the ratio dropped to 1.24:1 in 1937 and 1.66:1 in 1938. Our results confirm the findings of economist Frank Smith, who as part of a 1941 study on insider trading examined

share dealing by corporations holding 10% or more of a firm's shares and found that between January 1936 and June 1938 "the purchases and sales of corporations almost balanced."[106]

Figure 2: Percentage of Increases/Decreases, 1936-1938



Source: Compiled from S.E.C. filings

For those instances where corporate shareholdings changed, we calculated the size of the change, breaking matters down by reference to 1-5%, 5-10%, 10-25%, 25-50% and 50-100% categories. Our accuracy may have been compromised to some degree because we had to extrapolate backwards to data the SEC complied for its 1936 report on the total number of shares held by each corporation and to Moody's for the total number of shares outstanding for each corporation, but our calculations should offer instructive guidance on the general magnitude of the changes involved. Of the 129 instances in 1936, 1937 and 1938 where a company decreased its holding, the stake was unwound entirely in 36 cases and the decrease was between 50% and 100% of the relevant holding in 16 other instances. This means that in two out of five decrease

[106] SMITH, *supra* note 103, at 101-02.

scenarios (40.3%), the stake sold was larger than half. This, in isolation, was a sizeable proportion, but the likelihood of a sell-off of 50% or more in any one year nevertheless was very small (52 instances out of the 1253 holdings of 10% or more over a three year period, or 4.2%), thus confirming that intercorporate taxation of dividends did not prompt the "rapid dismantling of American business groups" to which Morck refers.

V. Explaining Why Intercorporate Taxation of Dividends Failed to Prompt Major Changes

If the introduction of intercorporate taxation of dividends in fact did little to induce corporations owning shares in publicly traded firms to unwind their holdings, why did the 1935 reforms fail to prompt a stronger response? The TNEC's verdict on the matter is instructive. As we have seen,[107] the TNEC argued the introduction of intercorporate taxation of dividends failed to have an appreciable impact on corporations. It said this was due in large measure to the modest tax hit – again, an effective tax rate of 2.25%, rising to 2.5% for 1938-39 when the top rate of income tax was increased to 16%.[108] Under such circumstances, the introduction of intercorporate taxation of dividends, while presumably unwelcome among corporate shareholders, was unlikely to prompt corporations to unwind rapidly ownership stakes they held in publicly traded firms.

There are other plausible reasons why the introduction of intercorporate taxation of dividends failed to displace corporate ownership of shares to the extent that might have been anticipated, but upon closer scrutiny they lack explanatory power. One possibility is that dividends were not a particularly important element of corporate finance, so that the change to

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[107] *Supra* note 67 and related discussion.

[108] TEMPORARY NATIONAL ECONOMIC COMMITTEE, *supra* note 65, at 60.

the law was largely beside the point for most firms. The significance of dividends does fluctuate over time, as illustrated by a dramatic reduction in the propensity of U.S. public companies to pay dividends in the 1990s.[109] Perhaps the 1930s were like the 1990s, which would imply that a change in the tax treatment of intercorporate dividends would be largely beside the point for companies owning equity in publicly traded firms.

Though plausible, a dividend irrelevance explanation for our results does not fit the facts. Dividends instead were a core element of corporate life at the relevant time. Before World War II, the dividend yield was the primary basis for valuing common stock in public corporations so firms were inclined to return a high proportion of earnings as dividends and strongly resisted reducing dividend pay-outs.[110] Adherence to the policy of maintaining the dividend was so strong that during the 1930s there were a number of years, including 1938, where among major public companies aggregate dividend payouts actually exceeded reported earnings.[111] Moreover, dividends were an important element of corporate finance. According to the TNEC's 1941 report on corporate taxation, during the mid-1930s between one-third and one-half of the profits distributed to shareholders were received by U.S. corporations.[112]

Even allowing for the fact dividends were important, it is possible that the status quo concerning corporate ownership of blocks of shares in public companies prevailed because of a

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[109] Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3 (2001).

[110] JONATHAN BARRON BASKIN & PAUL J. MISANTI, A HISTORY OF CORPORATE FINANCE 22, 195, 233 (1997) (dividends as a determinant of share prices; sizeable payouts); Donald E. Wilbur, *A Study of the Policy of Dividend Stabilization*, 10 HARV. BUS. REV. 373 (1932) (dividend policy stability).

[111] Jack W. Wilson & Charles P. Jones, *An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870-1999*, 75 J. BUS. 505, 529 (2002) (see figures listed under payout %).

[112] TEMPORARY NATIONAL ECONOMIC COMMITTEE, *supra* note 65, at 40. Chudson arrived at similar results in an independent review of the data, also noting that "over half of the [intercorporate] dividend disbursements were received by corporations with assets of $100,0000,000 or more." *See* WALTER A. CHUDSON, THE PATTERN OF CORPORATE FINANCIAL STRUCTURE: A CROSS-SECTION VIEW OF MANUFACTURING, MINING, TRADE, AND CONSTRUCTION, 1937 88 (1945).

substitution effect. If publicly traded firms could distribute cash to corporate shareholders in a form other than dividends, then there would have been little incentive to exit despite the introduction of taxation of intercorporate dividends. The share buyback constitutes the most obvious alternative strategy corporations can adopt to distribute cash to shareholders and the prevailing view in the 1930s was that a corporation could buy back its own outstanding shares so long as the purchase was made from retained earnings and did not prejudice creditors.[113]

It is unlikely, however, that 1930s companies in fact used share buybacks as a substitute for dividends. While buybacks did become more common after the 1929 stock market crash, companies that had engaged in stock repurchases were curtailing or abandoning the practice by the end of 1934 due to adverse publicity and concerns about violating prohibitions against manipulation of security prices in the Securities Exchange Act passed that year.[114] From that point onwards until at least the 1960s, the repurchasing of shares was not viewed as a means for distributing cash to shareholders but rather as a defensive device to be used to avoid dilution created by acquisitions, employee stock-purchase programs and stock option plans.[115]

Even for those public companies inclined to use share buybacks as a means to distribute cash to shareholders, the tax consequences could have been worse than a partially taxed intercorporate dividend. The potential stumbling block was that a recipient corporation would have had to pay tax at ordinary income rates on profits generated (if any) by the repurchase.[116] Unless the gains in question were modest, the corporate stockholder would have been better off

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[113] Paul W. Jones, *Redeemable Corporate Securities*, 5 S. CAL. L. REV. 83, 85-86 (1931).

[114] *Finance, Business, Economics*, WASH. POST, Dec. 26, 1934, at 18.

[115] Charles D. Ellis, *Repurchase Stock to Revitalize Equity*, 43 HARV. BUS. REV. 119 (1965) (urging companies to change their approach).

[116] "Long term" capital gains income was capped at maximum rate lower than the highest corporate rate from 1942 to 1987 but there was no capital gains preference during the period covered by our study. *See* JACK TAYLOR, INTERNAL REVENUE SERVICE, CORPORATION INCOME TAX BRACKETS AND RATES, 1909-2002 n.1 (2003), http://www.irs.gov/pub/irs-soi/02corate.pdf.

receiving the dividend and paying tax on the non-exempt portion. Thus, substituting share repurchases for intercorporate dividends would not have served as a viable tax planning strategy in most instances.

Even if dividends were important and there was no obvious substitute strategy that could be used to side-step the tax hit on intercorporate dividends, market conditions may have deterred exit, at least temporarily. Stock price performance was generally disappointing during the 1930s, as reflected by the fact that the Dow Jones Industrial Average was 248.5 at the beginning of the decade and 150.2 at the end.[117] In this sort of bear market, corporations owning shares in other firms conceivably were reluctant to sell out at a loss despite the introduction of intercorporate taxation of dividends.

Share prices dipped sharply in 1936 (Figure 3), which implies that corporations might indeed have sat tight despite the tax change. Otherwise, however, shares performed reasonably well during the 1936-38 period. Correspondingly, general market trends should not have been a stumbling block for companies inclined to respond to the taxation of intercorporate dividends by selling out.

Fig. 3: Share Prices 1936-38 (Dow Jones Industrial Average, prices at the beginning of each month)

[117] Derived from Dow Jones Industrial Average – 30 Stocks Index, http://www.econstats.com/eqty/eqem_mi_3.htm.



Source: Derived from Yahoo! Finance

To test more rigorously the extent to which general stock market trends might have impacted decisions companies made concerning the disposal or acquisition of shares in publicly traded firms, we ran tests regressing our monthly data on share ownership against month-to-month Dow Jones Industrial Average fluctuations. Based on our full sample, with this test the R^2 was 0.01 and the adjusted R^2 was -0.02, meaning there was no statistically significant correlation between share price movements and the buying or selling of shares by companies. There also were no statistically significant correlations once the companies were sub-categorized on a PUHCA/non-PUHCA/unclear basis.[118] These results confirm that the failure of companies to respond to the introduction of the intercorporate tax on dividends by unwinding stakes they held in public companies cannot be attributed to stock market trends. Given that dividends were an important feature of 1930s capital markets and that share repurchases did not provide a realistic means to side-step the taxation of intercorporate dividends, the modest tax rate is the most

[118] The full results are available on request.

plausible explanation why the change to the law did not dislodge markedly corporate ownership of shares in public companies.

VI. Pyramids as the Exception to the Rule: An Alternative Historical Explanation

Given that the introduction of intercorporate taxation of dividends in the 1930s did not prompt rapid dismantling of incumbent corporate pyramids, what does explain the rarity of pyramidal structures in the U.S.? It is beyond the scope of this paper to offer a definitive explanation. However, history does offer helpful hints.

One possible historically-oriented explanation for the paucity of corporate pyramids in the U.S. is that during the 1930s corporations implicated in pyramidal structures were being sideswiped by trends more potent than tax reform, namely mergers and bankruptcies. If numerous public companies in which other companies owned sizeable stakes were disappearing because they were acquired or were closed down due to financial distress our S.E.C. ownership filing data would create a misleading impression of stability. Follow up searches we conducted indicate, however, this was not what was going on.

Among the 331 companies in the original SEC volume that had a corporate shareholder owning 10% or more of the common shares as of year-end 1935, 47 "disappeared" in 1936, in the sense there were no reports subsequently of any change in share ownership, whether by directors, officers or shareholders owning 10% or more of the shares. Among the companies for which ownership disclosure occurred in 1936 there were five for which no changes in share ownership was reported for 1937 or 1938 and of the companies for which ownership disclosures were reported in 1936 and 1937, 12 "disappeared" in this way in 1938. With this cohort of 64 companies, the most obvious explanation why they "disappeared" was that there were no changes in stakes held by any shareholders required to report their holdings, meaning no

reporting took place. It is theoretically possible, however, that the companies fell off the radar screen because they were bought up and removed from the stock market, whether by the corporate shareholder owning 10% or more of the shares or by another acquirer, or because they ceased to operate due to financial distress. To the extent this occurred, then a major simplification of corporate ownership structures would have occurred without being reflected in our data. To investigate, we carried out for the three years under study searches for each of the 64 companies using Moody's corporate manuals and the *ProQuest* Historical Newspaper Database.

Among the cohort of 64 companies, the available evidence indicates there were only three disappearances due to acquisition, with the firms involved being Gulf States Steel Co., Plutus Mining Corp. and Samson Corp.[119] Three other companies went out of business due to bankruptcy, namely Continental Securities Corp., Schulte Retail Stores Corp. and the Western Pacific Railroad. The low disappearance by acquisition figure can be accounted for readily by the fact that the period between 1932 and 1942 was noted for an absence of merger activity.[120] The financial distress number is more surprising, given the economic turmoil during the 1930s. However, it appears that the difficult business conditions did not result in widespread bankruptcies among publicly traded companies. Searches of the Center for Research in Security Prices, which offers monthly data on corporations traded on the New York Stock Exchange back to 1925, indicate that there were only 31 de-listings between 1936 and 1938 and Dun & Bradstreet's *Business Failure Record* reports that there were only 32 instances in 1936 where a company ceased to do business or was reorganized due to financial distress when liabilities

[119] There were two other companies, Golden State Co. and Standard Investing, where an acquirer bought up a stake of close to 50% but apparently went no further. On Standard Investing, see *Standard Investing Corp. Control Changes Hands*, WALL ST. J., Jan. 12, 1937, at 10.

[120] RALPH L. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY 1895-1956 122 (1959).

exceeded $1 million, and the number dropped to 21 in 1937 and 20 in 1938.[121] The upshot is that market forces, at least in the form of mergers or bankruptcy, were having at best a marginal impact on corporate pyramids during the period covered by our study.

It likely is necessary to go back further in time to account satisfactorily for the historic dearth of corporate pyramids in the U.S. When Morck claims the introduction of intercorporate taxation of dividends reconfigured corporate America, he relies heavily on the premise that corporate pyramids were a prominent feature of the corporate landscape prior to the mid-1930s. As he says "Pyramidal corporate groups were introduced to the United States in 1889 and became commonplace by the 1920s."[122] To the extent this is correct, with pyramids now being the exception to the rule in the U.S., researchers logically will search for a moment or event which caused them to disappear. Our empirical findings indicate introduction of intercorporate taxation of dividends was not the event in question. A possible response might be to search for a different agent of change. Doing so presupposes corporate pyramids were indeed a prevalent feature of the U.S. corporate landscape prior to the mid-1930s. The available evidence suggests they in fact were not.

There is a dearth of hard data on ownership patterns in publicly traded companies for the period prior to that covered by our study, in large measure because until the introduction of federal securities law in the mid-1930s corporations and their stockholders were not compelled to disclose the sort of information relied on for the purposes of this study. Research done by

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[121] http://www.crsp.com/products/indices.htm (setting out coverage of the Center for Research in Security Prices; further details on searches done are available on request); THE DUN & BRADSTREET CORP., THE FAILURE RECORD THROUGH 1961 7 (1962). Dun & Bradstreet did not provide data, however, on failures of banks, insurance companies or other financial companies. *See* OSCAR SCOTT, LIBRARY OF CONGRESS, CONGRESSIONAL RESEARCH SERVICE, BANKRUPTCY AND BUSINESS FAILURE DATA 1 (1984), *available at* http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-9037:1.

[122] MORCK, *How to Eliminate*, *supra* note 5, at 148.

economist Gardiner Means stands out as an exception. Means relied on press reports and trade publications such as Standard Corporation Records and Moody's industrial and public utilities manuals to generate the only systematic collation of pre-1935 data on ownership patterns in major U.S. corporations.[123] Means' research was a core element of his famous work with Adolf Berle[124] and also featured prominently in *The Holding Company*, a 1932 volume co-written with economist James Bonbright.[125]

Though Berle and Means, like Morck, drew attention to the Van Sweringen empire to illustrate the nature of corporate pyramids, Means' research shows this sort of complicated multi-layered corporate structure was atypical. Berle and Means' study, which provided data on the ownership structure of the largest 200 non-financial corporations in the U.S. as of 1929, indicated that of the 106 industrial enterprises in the sample just 10 (9.4%) had pyramidal ownership features.[126] The Bonbright and Means' study indicated similarly that pyramids were the exception to the rule in the industrial sector.

Bonbright and Means found that among the 97 largest industrial corporations as of 1929 only four were pure operating companies, and thus could not have been at the apex of a corporate pyramid. On the other hand, among the other 93, 72 were parent companies, meaning they had a

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[123] On data sources, see BERLE & MEANS, *supra* note 35, 84-85, Table XIII. On the pioneering nature of this research, see Brian Cheffins & Steven Bank, *Is Berle and Means Really a Myth?*, 83 BUS. HIST. REV. 443, 453 (2009).

[124] Berle and Means' data on ownership and control in THE MODERN CORPORATION & PRIVATE PROPERTY drew heavily from Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q. J. ECON. 68 (1931).

[125] BONBRIGHT AND MEANS, *supra* note 22.

[126] Compiled from BERLE & MEANS, *supra* note 35, Table XIII. Berle and Means' basic control taxonomy was "management control", "legal device", "minority control", "majority ownership" and "private ownership". Pyramiding was treated as a means of control by "legal device", and for those companies where there was any doubt about the ownership categorization (i.e. there was no majority shareholder and ownership was not highly diffuse), Berle and Means specifically indicated in Table XIII whether ultimate control was achieved by pyramiding or was of a different sort.

significant operating aspect, and the vast majority of these (59) were primarily operating companies.[127] With these parent companies, their subsidiary companies were usually wholly-owned, or close to it. As Bonbright and Means said, there had been over a period of years a "definite tendency for the industrial company to acquire all, or practically all, of the stock of its subsidiaries."[128] For instance, as of 1933 the United States Rubber Company had 62 wholly owned operating subsidiary companies.[129] The upshot, as the *Wall Street Journal* observed in 1932 when discussing consolidated balance sheets, "Most of the big corporate enterprises of modern times are a combination of various units. These units are separate entities….But together they form the whole enterprise."[130]

The remaining 21 of the 97 large industrial enterprises lacked a significant operating aspect – Bonbright and Means categorized the firms as pure holding companies – and thus were promising candidates to be at the apex of a corporate pyramid. However, even among these 21, it appears corporate pyramids were the exception to the rule. Bonbright and Means reported that 15 had insignificant minority interests in other corporations. Of the remaining six companies, only two made a pyramid-style practice of holding less than the maximum stock interest that they could obtain under the circumstances.[131] Bonbright and Means correspondingly said of the 21 companies there was "relatively little indication that pyramiding is resorted to as a permanent policy in the industrial field."[132]

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[127] *Id.* at 77.

[128] *Id.* at 79; *see also Holding Firm Abuse Mostly in Utility Field*, CHI. DAILY TRIB., Jan. 30, 1938, at B5 [hereinafter *Holding Firm Abuse*].

[129] *U.S. Steel*, *supra* note 94.

[130] *Dear George –*, WALL ST. J., Nov. 3, 1932, at 6.

[131] BONBRIGHT & MEANS, *supra* note 22, at 81.

[132] *Id.* at 80; *see also id.* at 87.

The pattern was similar with railways. Of the 42 railway companies in Berle and Means' study only seven (16.7%) were identified as having pyramidal ownership features.[133] Similarly, Bonbright and Means report that as of 1930 independent, stand-alone corporations owned and operated 51% of all railway mileage.[134] A further 22% was operated by subsidiaries of operating companies in which the operating company held a controlling stake.[135] Only 19% of all railway mileage was under the ultimate control of companies likely to be at the apex of a corporate pyramid, namely those lacking a significant operating aspect.[136] Not surprisingly, then, a 1932 text on business organizations observed that "Among railroads it [the holding company device] has attracted attention only in special cases….."[137] Similarly, according to a study of 20th century transport policy, "The Van Sweringens were relatively unique in their speculative approach to rail carriers…."[138]

Utilities were a different proposition. The list of 30 major U.S. corporations the Twentieth Century Fund identified in its 1937 study of taxation as having recently eliminated holding company structures illustrates the point.[139] As Table 1 indicates, among the seven of the 30 companies that were part of pyramidal structures, there were no railways, no industrial companies, one investment/financial company and six utility companies. Data that Means compiled confirms that pyramids were more prevalent in the utilities industry than elsewhere.

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[133] Compiled from BERLE & MEANS, *supra* note 35, Table XIII.

[134] More precisely, 37% fell into this category, but 14% was operated by such enterprises by lease or agreement.

[135] BONBRIGHT & MEANS, *supra* note 22, at 228.

[136] *Id.* at 227-28 (attributing the 19% figure to pure holding companies rather than corporate pyramids).

[137] CHARLES S. TIPPETTS & SHAW LIVERMORE, BUSINESS ORGANIZATION AND CONTROL: CORPORATIONS AND TRUSTS IN THE UNITED STATES 229 (1st ed. 1932).

[138] ROSE ET AL., *supra* note 38, at 26.

[139] MORCK, *How to Eliminate*, *supra* note 5, at 148 (acknowledging this point, saying "the largest U.S. pyramids were built around utility companies").

Of the 52 utility companies in Berle and Means' sample of the 200 largest non-financial companies, 14 (26.9%) had pyramidal ownership features, a considerably higher proportion than for industrial companies and railways.[140]

Bonbright and Means do not address directly the question of how prevalent pyramidal structures were in the utilities sector. They do report that as of 1931 72% of national electric power output was generated and distributed by subsidiaries of pure holding companies, organized around nine major systems, and that 42% of national gas sales were accounted for by subsidiaries of pure holding companies, organized around sixteen holding company systems.[141] They fail to specify, however, whether the holding company systems in the utilities sector were pyramidal in orientation. Many in fact likely were. A 1938 commentary on utilities said that, in contrast to industrial companies, "utility holding companies were able to extend their control over a large number of properties by investing a relatively small amount of capital in the junior voting shares (i.e. common stock)…Frequently less than a majority of the shares was needed to obtain practical working control."[142] A 1940 study of U.S. business observed similarly "So great was the importance of pyramiding holding companies in the utilities industries in the decade from 1920 to 1930 that the terms 'holding company' and 'public utility company' became synonymous in the public mind."[143]

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[140] Compiled from BERLE & MEANS, *supra* note 35, Table XIII.

[141] BONBRIGHT & MEANS, *supra* note 22, at 91, 95. Bonbright and Means said there were ten groups, but indicated one (Consolidated Gas of NY) was not a holding company (at 114).

[142] *Holding Firm Abuse*, *supra* note 128.

[143] TIPPETTS & LIVERMORE (1941), *supra* note 20, at 184. *See also* EBASCO SERVICES, INC., ELECTRIC UTILITY FINANCING 22-23 (1948).

The Electric Bond and Share Company, formed in 1905 by General Electric interests, illustrates the pattern.[144] Electric Bond and Share was the apex of the corporate pyramid, with the next layer being five major sub-holding companies in which Electric Bond and Share held a stake of between 17% and 54%. The sub-holding companies in turn controlled subsidiary operating companies, sometimes by direct ownership of all or a majority of the common stock and sometimes through the device of an intermediate parent company or holding company.[145]

The prevalence of complicated corporate structures among utilities was largely due to technical, financial and legal factors specific to the utilities sector. At the turn of the 20th century, electrical and gas utilities were typically small, isolated, locally owned and controlled, and financially weak.[146] The companies typically could not finance necessary capital outlays through retained earnings and found it very difficult to raise funds by issuing equity and debt because the risk to investors was very high.[147] One response was for engineering and manufacturing groups specializing in supplying utilities with equipment and related services to take up a sizeable stake in shares and/or bonds in lieu of payment. The securities could then be transferred to a holding company, which in turn would market its equity and debt to the public.[148] The Electric Bond and Share Company was established along these lines.

A second response was for dynamic, ambitious utility executives to use a holding company to sweep weaker enterprises under their control, with benefits accruing in the form of dividends and management fees paid by the companies acquired. Samuel Insull's utilities empire

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[144] BONBRIGHT & MEANS, *supra* note 22, at 101-07.

[145] For a diagram of the corporate structure, see *id.* at 105.

[146] *Id.* at 91, 101-2; Norman S. Buchanan, *The Origin and Development of the Public Utility Holding Company*, 44 J. POL. ECON. 31, 32-33, 43 (1936).

[147] William J. Hausman & John L. Neufeld, *The Market for Capital and the Origins of State Regulation of Electrical Utilities in the United States*, 62 J. ECON. HIST. 1050, 1053 (2002).

[148] BONBRIGHT & MEANS, *supra* note 22, at 98-108; HUGHES, *supra* note 49, at 395-98.

was built up in this fashion.[149] Third and finally, investment banks sponsoring capital-raising by utilities could opt to organize matters through corporate vehicles owning sizeable stakes in the operating companies. The marketability of the securities of the corporate intermediaries was enhanced because the holding companies reputedly served to spread risk on behalf of investors and promised investors a steady flow of income based on dividends received from operating companies and fees charged for the provision of technical advice by skilled utilities experts. The United Corporation, the largest of all utility groups by 1930, was the most ambitious system of this sort, having been created and sponsored in 1929 by powerful investment banks J.P Morgan & Co., Drexel & Co. and Bonbright & Co.[150]

While the fractionalized, capital-intensive nature of the early 20th century utilities industry provided a congenial environment for corporate affiliations, various factors precluded wholesale consolidation of operating units under the umbrella of parent companies. Cost was one. While outright consolidation implied having to buy up all of the equity and perhaps the outstanding debt of operating companies, *de facto* control of operating companies typically could be obtained simply by acquiring a large block of voting shares.[151]

Legal hurdles also discouraged wholesale consolidation. As late as 1935, only 33 states had provisions in corporate legislation authorizing full-blown corporate mergers, which meant that in a sizeable minority of states an outright merger of utility companies encompassed by a corporate group could only proceed with the backing of a special legislative act or specifically

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[149] Louther Horne, *The Insull Utility Empire: Its Amazing Rise and Fall*, N.Y. TIMES, Oct. 9, 1932, at XX3; ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET 243-44 (1st ed. 1965).

[150] BONBRIGHT & MEANS, *supra* note 22, at 127-36; HUGHES, *supra* note 49, at 400-01.

[151] BONBRIGHT & MEANS, *supra* note 22, at 31-32.

tailored charter provisions.[152] Even when state corporate law did authorize a merger, the assent of a prescribed super-majority of shareholders, frequently including security holders not otherwise entitled to voting rights, was typically required. A dissenting minority could be well positioned to hold up a merger by challenging the fairness of the plan or by insisting on being cashed out via appraisal rights, options unavailable if control was obtained through buying up a sizeable percentage of voting shares.[153]

Regulatory considerations also came into play. Many states made it either obligatory or practically essential (e.g. by precluding "foreign" corporations from exercising rights of eminent domain) for public utility companies doing business within their boundaries to incorporate domestically.[154] Such restrictions strongly discouraged complete fusion of formerly independent public utility companies within larger utility groups. Moreover, when utility enterprises brought within a larger corporate group retained a distinct corporate identity this facilitated the side-stepping of regulation by state public service commissions vested with control over rate-setting, accounting issues and service provision.[155] If the operating entities were merged directly with corporations further up the hierarchy of a public utility group, the jurisdiction of these commissions could well have extended over the entire system. A public utility group, by keeping the operating companies legally separate from units offering managerial, financial and engineering services, could ensure state regulation only occurred at the operating company level.

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[152] Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1355 (1999).

[153] BONBRIGHT & MEANS, *supra* note 22, at 30; Flynn, *supra* note 51, at 16.

[154] BONBRIGHT & MEANS, *supra* note 22, at 33; Flynn, *supra* note 51, at 16; WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 296-97 (Little, Brown, and Co. 1st ed. 1927).

[155] BONBRIGHT & MEANS, supra note 22, at 36-37.

Given the notoriety of the Van Sweringen corporate pyramid and the multi-state scale on which railways operated, it might have been expected railroads would have been characterized by pyramidal structures in the same way as electrical and gas utilities. One reason the pattern differed was that railway organization was characterized by a greater tendency in favour of centralization.[156] With the major utility groups that had emerged by the 1930s, the systems typically were composed of numerous operating units distributed too widely in geographic terms to operate effectively as a single enterprise. With railways, in contrast, the constituent parts of a railway system could typically be welded together readily into a physically integrated and centrally operated network.

With railways, history also mattered.[157] In the railway sector, the corporate structure was largely fixed by 1889 when New Jersey led the way among the states in making the holding company available for corporations by permitting a corporation to own stock in other corporate enterprises.[158] In contrast, as the major utility systems took shape in the opening decades of the 20th century, their organizers had full scope to take advantage of the state corporate statutes that cleared the way for the use of a holding company structure.

Regulatory factors also came into play, in that until the 1920s railways lacked the legal impetus utilities had to organize through the medium of holding companies.[159] As soon as states began to enact public service laws regulating companies operating as utilities, public utility

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[156] *Id.* at 225.

[157] *Id.* at 224-25.

[158] There were earlier examples of holding companies – such as the Pennsylvania Company, holding company of the Pennsylvania Railroad properties west of Pittsburgh, which was started in 1870 – but these early holding companies received the authorization to hold stock in other corporations through special legislation enacted as part of the grant of their corporate charter. *See* Maurice H. Robinson, *The Holding Corporation*, 18 YALE REV. 390, 400-06 (1910); TIPPETTS & LIVERMORE (1941), *supra* note 20, at 183-84.

[159] BONBRIGHT & MEANS, *supra* note 22, at 225-26.

operators had an incentive to channel matters through holding companies to ameliorate state control over rate setting, accounting and service provision. For railway operators, their primary concern was federal regulation, and up to 1920 there were no serious restrictions on operating companies from which a holding company might offer an escape.

Matters changed with the enactment of the Transportation Act of 1920.[160] Under this legislation the Interstate Commerce Commission was given wide-ranging authority over railways, including powers to fix rates charged and to veto proposed issuances of securities, abandonments of service, board appointments and railway mergers.[161] The holding company mechanism afforded a means of side-stepping these restrictions, as ICC commissioners and the courts took the view that the ICC lacked legal authority to regulate a company that owned shares in railway companies but did not operate its own railroad.[162]

The Van Sweringen brothers were not the only railway executives to take advantage of this loophole. The Pennsylvania Railroad, a powerful railway operator in its own right, incorporated in 1929 the Pennroad Corporation to function as a holding company that would purchase shares in strategic railroad properties. While Pennsylvania Railroad directors dominated the Pennroad board, the Pennsylvania Railroad took no shares in its creation. Instead, to foster "continuity and stability of policy and management" Pennroad's shares were put in a voting trust, meaning purchasers of Pennroad shares received only a trust certificate to be exchanged for the actual shares in 1939.[163] Still, despite the Van Sweringen brothers and Pennroad, the fact that organizing a railway system through the medium of a holding company

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[160] 41 Stat. 456 (1920).

[161] ROSE ET AL., *supra* note 38, at 4, 25.

[162] BONBRIGHT & MEANS, supra note 22, at 271-72; ROSE ET AL., *supra* note 38, at 25.

[163] SAUNDERS, *supra* note 37, at 79; BONBRIGHT & MEANS, *supra* note 22, at 232-33, 263-67; FERDINAND PECORA, WALL STREET UNDER OATH 57-59 (1st ed. 1939).

only became advantageous from a regulatory perspective in 1920 helped to ensure that as of the 1930s corporate structures in the railway sector were less complicated than they were in the utility sector.

The upshot is that, the utilities industry aside, corporate pyramids were the exception to the rule in the U.S. prior to the mid-1930s. Correspondingly, even if the introduction of intercorporate taxation of dividends encouraged the dismantling of pyramidal structures, there were not a large number susceptible to dismemberment by the mid-1930s. Hence, the fact that corporate pyramids were not a predominant feature of industrial firms or railroads even prior to the 1930s likely does more to account for the subsequent rarity of corporate pyramids in the U.S. than legislation during the New Deal.

VII. The Dismantling of the Utilities Pyramids

Though historical trends likely do more than the introduction of intercorporate taxation of dividends to account for the paucity of pyramids in the U.S., the utilities industry merits additional analysis because pyramidal structures were a fixture in this sector. By the late 1940s virtually all utility holding companies had undergone substantial simplification or integration.[164] Did the introduction of the taxation of intercorporate dividends have a role to play here? Our data suggests not. With companies subject to the Public Utilities Holding Company Act, holdings of 10% or larger by corporations remained static in 82% of cases in 1936 and 91% in both 1937 and 1938. Over the three year period under study, there were only two instances out of 210 holdings involving a PUHCA company where the stake was disposed of entirely, with

[164] ENERGY INFORMATION ADMINISTRATION, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935: 1935-1992 12 (1993).

both such disposals occurring in 1938. The PUHCA itself, however, ultimately did prompt substantial changes.

As Part III.B discussed, of the six utilities on the list of 30 major U.S. corporations the Twentieth Century Fund identified in its 1937 study of taxation as having recently eliminated holding company structures, five specifically cited the PUHCA as a reason.[165] This should not be surprising, given that the primary objective of the PUHCA was to "eliminate the evils connected with public utility holding companies which are engaged in interstate commerce."[166] The Act required any electric or gas utility company operating on an interstate basis to register with the SEC, which in turn was empowered to institute proceedings to force holding companies to divest their stakes in other firms until they became a single integrated system serving a limited geographic area.[167] The SEC also could impose a "death sentence" on any utility holding company that was more than three times removed from any of its subsidiaries.[168]

While developments concerning the 30 corporations analyzed in the Twentieth Century Fund's 1937 study indicated the PUHCA prompted some immediate changes its full impact was delayed, with resistance being a common response. After the PUHCA was enacted, 58 cases were brought challenging its constitutionality and some 200 injunctions were issued by courts around the country to block the SEC from enforcing the legislation.[169] In 1938 the U.S. Supreme Court upheld the constitutionality of the provisions in the PUHCA requiring registration with the

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[165] See *supra* notes 88 to 92 and accompanying text; Table 1.

[166] ENERGY INFORMATION ADMINISTRATION, *supra* note 164, at 9 (quoting a 1947 study of the utility industry).

[167] *Id.* at 9, 11.

[168] Jerry W. Markham, *Volume II: From J.P. Morgan to the Institutional Investor (1900-1970), in* A FINANCIAL HISTORY OF THE UNITED STATES 205-6 (2002).

[169] ENERGY INFORMATION ADMINISTRATION, *supra* note 164, at 11; Markham, *supra* note 168, at 206.

SEC.[170] Various holding companies followed up by making use of provisions of the Act that permitted them to prepare their own plans for compliance.[171] Still, progress remained slow.

As of 1944 the SEC had issued most of the orders necessary to integrate and simplify the utility industry but only 22% of the assets involved had actually been divested.[172] A stumbling block was that it was not until 1946 that the Supreme Court confirmed that the SEC had the authority to compel the reorganization and economic integration of public utility holding companies.[173] Matters moved on quickly from there, because by 1950 the utility reorganizations were virtually complete.[174] This meant the death knell for the complex corporate pyramid in the one economic sector where it truly flourished. Thus, to the extent regulation contributed to the dearth of corporate pyramids in the U.S., legislation specifically targeting utilities was the catalyst rather than the taxation of intercorporate dividends.

VIII. Conclusion

Much like popular fables, the conventional wisdom on corporate pyramids offers a moral for those skeptical of the sprawling business empires that pyramidal corporate structures can constitute, namely that vigilance on the part of lawmakers can provide a cure to this particular corporate governance ailment. Pyramidal business groups reputedly became an important part of the U.S. corporate landscape during the opening decades of the 20th century, which exposed investors to potential exploitation and created broader economic and political risks due to an unhealthy concentration of economic power. New Deal policymakers, conscious of the dangers

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[170] Elec. Bond & Share Co. v. SEC, 303 U.S. 419 (1938).

[171] ENERGY INFORMATION ADMINISTRATION, *supra* note 164, at 11.

[172] *The Utility Industry*, WALL ST. J., Oct. 18, 1944, at 7.

[173] N. American Co. v. SEC, 327 U.S. 686 (1946); ENERGY INFORMATION ADMINISTRATION, *supra* note 164, at 11.

[174] ENERGY INFORMATION ADMINISTRATION, *supra* note 164, at 12.

involved, targeted pyramidal structures, with the primary weapon being the introduction of taxation of intercorporate dividends. The U.S. still reaps the benefits of the astute intervention by the New Dealers, or so the story goes, as its system of corporate governance remains largely free of the affliction of corporate pyramids.

Our research offers a rather more ambiguous picture. Various New Deal tax initiatives were designed to foster simplification of corporate structures. However, these reforms generally did not target multi-layered corporate pyramids *per se* and did not appear to lead to the wholesale retreat from the pyramid device implied by the conventional wisdom. Instead, to the extent various corporate tax reforms enacted during the New Deal, including the intercorporate dividend tax, were intended to foster corporate restructuring, they apparently were directed towards a less nefarious target, namely the holding company at the apex of a corporate group composed of a sizeable number of subsidiary operating companies, typically wholly owned. This was a perfectly sensible approach for policymakers to take, given that multi-layered corporate pyramids oriented around companies where the public continued to hold sizeable stakes were generally the exception to the rule. The utilities sector was different, but here the federal government enacted the PUHCA to address specifically the corporate structures that had developed there.

While corporate pyramids are currently rarer in the U.S. than they are in most countries, corporate blockholding in public companies is by no means unknown. Barclay, Holderness and Sheehan report that as of 1995 34% of a random sample of 376 public companies had one or

more corporate blockholder owning at least 5% of the stock.[175] Why has such corporate blockholding not taken the form of pyramidal groups?

As we have argued, history has likely played an important role, in that corporate pyramids were not commonplace outside of the utilities sector prior to the 1930s. The Clayton Act of 1914 could have been a factor, in that it stipulated that it was illegal for a corporation engaged in interstate commerce to acquire the stock of another corporation if the result might be a substantial lessening of competition.[176] Regulation, however, may not have played the dominant role in dictating the role of pyramidal structures in U.S. corporate governance. Masulis, Pham and Zein report on the basis of their analysis of the prevalence of corporate pyramids in 45 countries that access to capital does more to explain matters than regulatory variables.[177] The underlying logic is that, while corporate pyramids languish when capital markets are well developed, pyramidal structures can thrive if capital is scarce because prosperous and well-regarded entrepreneurs and family groups can use their "brand name" to back promising ventures successfully. Their findings accord with the history of utilities in the U.S., in that the difficulties locally-based utility companies faced raising capital helped to provide the catalyst for the utility empires that became dominant by the 1930s. Hence, the well-developed financial markets from which the U.S. has benefited may do considerably more to explain the rarity of corporate pyramids than do tax or other regulatory variables.

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[175] Barclay et al., *supra* note 105, at 2437.

[176] 38 Stat. 730 (1914). On this point, see Klaus Gugler, Dennis C. Mueller & B. Burcin Yurtoglu, *Insider Ownership, Ownership Concentration and Investment Performance: An International Comparison*, 14 J. CORP. FIN. 688, 696 (2008) (citing, however, §8, which dealt with interlocking directorships, rather than §7). *See also* BONBRIGHT & MEANS, *supra* note 22, at 72-75 (discussing the impact the Clayton Act on the use of the holding company in horizontal consolidations). However, there remained substantial scope for complicated corporate structures to emerge with non-competing properties. *Id.* at 75-76, 78.

[177] Masulis et al., *supra* note 7, at 35-40.

The fact that market forces may do more than regulatory variables to explain why corporate pyramids have been the exception to the rule in the United States has broader implications for corporate governance research. Economists Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny provided the catalyst for law-oriented explanations that currently dominate debates on rates of stock market development and patterns of corporate ownership with studies indicating that high scores on an index designed to measure the "quality" of corporate law correlated with well-developed stock markets and dispersed share ownership.[178] However, follow up research has revealed coding errors and suggests that once these are corrected many of the correlations La Porta *et al.* reported – including those involving share ownership patterns -- disappear.[179] This implies that those seeking to explain key features of the corporate landscape in a particular country and across countries need to take into account determinants other than law. Our analysis of the impact of intercorporate taxation of dividends during the 1930s indicates that at least with respect to corporate pyramids this sort of broadly based inquiry is in order.

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[178] *See* La Porta et al., *Corporate Ownership, supra* note 3; La Porta et al., *Law and Finance, supra* note 3.

[179] Holger Spamann, *The "Antidirector Rights Index" Revisited*, REV. FIN. STUD. (forthcoming 2010).

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