



UNC
SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 9 | Number 4

Article 16

6-1-1931

Public Utilities -- Regulation of Contracts With Holding and Affiliated Corporations

James A. Williams

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

Recommended Citation

James A. Williams, *Public Utilities -- Regulation of Contracts With Holding and Affiliated Corporations*, 9 N.C. L. REV. 463 (1931).
Available at: <http://scholarship.law.unc.edu/nclr/vol9/iss4/16>

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

possession after default,¹⁸ while a mortgagee is not.¹⁹ In respect to foreclosure there seems no advantage, it being accomplished by this novel method: the grantee reduces his claim to judgment, reconveys the property to the grantor, and then levies an execution on it.²⁰ The reconveyance puts title in the debtor only for the purpose of levy and sale, and except for such purpose is declared to be a "mere escrow." Liens of third parties therefore do not attach.²¹

This "strange device," the security deed, is peculiar to Georgia.²² It is apparently an anachronism. One of the early common law forms of security was a conveyance in fee, the creditor promising to reconvey upon payment of the debt,²³ and the security deed seems a modern adaptation of this ancient expedient. While elsewhere the mortgage and deed of trust have overshadowed other security plants, in Georgia the security deed has flourished; and due to its peculiar attributes, it will no doubt continue to hold its place in the sun.²⁴

HUGH L. LOBDELL.

Public Utilities—Regulation of Contracts With Holding and Affiliated Corporations.

In establishing a rate base for a local public utility, can a state public service commission demand a statement of the cost to the associated foreign corporation in each case: (1) of services to a local public utility rendered by a foreign holding company under a "service and management" contract; (2) of equipment sold to a local public utility by an affiliated foreign corporation? These two problems were raised and answered in the affirmative by the Supreme Court of the United States in the case of *Smith v. Illinois Bell Telephone Co.*¹ All contracts entered into by a public utility must be fair

¹⁸ *Thaxton v. Roberts*, 66 Ga. 704 (1881).

¹⁹ *Elfe v. Cole*, 26 Ga. 197 (1858).

²⁰ GA. ANN. CODE (Michie, 1926) §6037.

²¹ *Carlton v. Reeves*, 157 Ga. 602, 122 S. E. 320 (1924).

²² 1 JONES, MORTGAGES (8th ed. 1928) §354.

²³ 3 HOLDSWORTH, HISTORY OF ENGLISH LAW (3rd ed. 1923) 129.

²⁴ The security deed is impracticable in North Carolina. An absolute conveyance intended merely as security is held void as to creditors, the decisions being placed on the recording statutes. *Holcombe v. Ray*, 23 N. C. 340 (1840); *Gulley v. Macy*, 84 N. C. 434 (1881).

¹ 282 U. S. 133, 51 Sup. Ct. 65, 75 L. ed. 99 (1930). The chronological history of this case is interesting in that after seven years litigation the case was remanded for a new trial. See *Smith et al. v. Illinois Bell Teleph. Co.*, 269 U. S. 531, 46 Sup. Ct. 22, 70 L. ed. 297 (1925) (restraining order affirmed); *Moynihan et al. (City of Chicago, Intervenor) v. Illinois Bell Teleph. Co.*, 38 F. (2d) 77 (N. D. Ill. 1930) (permanent injunction granted because commis-

and reasonable,² and made with the interest of the utility in mind, else their inclusion in the rate base will lead to excessive capitalization³ and excessive allowance for operating expense,⁴ and ultimately to unfair rates to the consuming public.

The Service Contract with the Holding Company.

The American Telephone and Telegraph Co. owned 99% of the stock of the Illinois Bell Telephone Co. Under a "license and service contract," the Illinois Co. was permitted to use instruments belonging to the American Co. and received other enumerated services⁵ for a return of 4½% of the gross yearly revenue of the Illinois Co. In 1927 the American Co. sold the rented instruments to the Illinois Co. and reduced the service rate to 2%. In 1929 the rate was further reduced to 1½%. The *Smith* case holds that there should be a specific finding by the special three judge district court of the cost to the American Co. of rendering these services to the Illinois Co., and of the reasonable amount which should be allowed to the operating expenses of the Illinois Co.⁶

With no fraud or bad faith appearing, the "percentage of gross revenue" contract has been sustained as having been made within the discretion of the directors of the subsidiary company.⁷ The right of compensation for these services is generally conceded, but much criticism's order in violation of the Fourteenth Amend.); *Smith v. Illinois Bell Teleph. Co.*, *supra* (remanded to special three judge district court for special findings of fact).

² *Union Dry Goods Co. v. Ga. Pub. Service Corp.*, 248 U. S. 372, 39 Sup. Ct. 117, 73 L. ed. 309, 9 A. L. R. 1420 (1919); *Fort Smith Spelter Co. v. Clear Creek Oil & Gas Co.*, 267 U. S. 231, 45 Sup. Ct. 263, 69 L. ed. 588 (1925).

³ *Logan Gas Co. v. Pub. Service Comm. of Ohio*, 121 Ohio St. 507, 169 N. E. 575; 2 SPURR, GUIDING PRINCIPLES OF PUBLIC SERVICE REGULATION (1925) 64. For examples of capitalized properties see *ibid.*, 64-78.

⁴ *Reno Power, Light & Water Co. v. Pub. Service Comm.*, 298 Fed. 790 (D. C. Nev. 1923); *Mobile Gas Co. v. Patterson*, 293 Fed. 208 (M. D. Ala. 1923); *Consolidated Gas Co. v. Newton*, 258 U. S. 165, 42 Sup. Ct. 264, 66 L. ed. 538 (1920); *Chicago & G. T. Ry. Co. v. Wellman*, 143 U. S. 339, 12 Sup. Ct. 450, 36 L. ed. 176 (1892); *St. Louis & O'Fallon Ry. Co. v. Interstate Commerce Comm.*, 279 U. S. 461, 49 Sup. Ct. 384, 73 L. ed. 798 (1928).

⁵ (1) Instrument Service; (2) General Staff Service, (a) Dept. of Development and Research, (b) Dept. of Operation and Engineering, (c) Dept. of Accounts and Finance, (d) Dept. of Law, (e) Dept. of Information and Publicity. Classified by GRONINGER, PUBLIC UTILITY RATE MAKING (1928) 191-200.

⁶ *Smith v. Ill. Bell Teleph. Co.*, *supra* note 1. But the court does not show how the cost is to be ascertained.

⁷ *Houston v. Southwestern Bell Teleph. Co.*, 259 U. S. 318, 42 Sup. Ct. 486, 66 L. ed. 961 (1922); *Missouri ex rel Southwestern Bell Teleph. Co. v. Public Service Comm.*, 262 U. S. 276, 43 Sup. Ct. 544, 67 L. ed. 981, 31 A. L. R. 807 (1923); 2 SPURR, *op. cit. supra* note 3, 670-689; Lilienthal, *The Regulation of Public Utility Holding Companies* (1929) 29 COL. L. REV. 404, 412.

icism has been directed toward the basis of computation. Commissions and authors have characterized the contract as "inequitable and illogical"⁸ and "unscientific and easily susceptible of abuse."⁹ The 4½% contract has been disallowed and a lump sum allowed as operating expense,¹⁰ and a per station payment in place of a percentage of the gross revenue basis has been attempted.¹¹

The Michigan Supreme Court in *quo warranto* proceedings ousted the Michigan Bell Telephone Co. from the right to have credit in a computation of rates for payments to the American Co. under the 4½% license and management contract.¹² But the force of the decision was negated by an amendment to the decree allowing "the reasonable value of the services rendered and the facilities furnished."¹³ Refusing to follow the state court's apparent desire to disregard the corporate entity of the local company, the special three judge district court stated in a collateral case that the profits of a manufacturing company furnishing equipment could not be considered in determining rates, though both seller and purchaser were subsidiaries of the same parent company.¹⁴

⁸ "Inequitable" because the American Co. is the real owner of the subsidiary and makes added profits on these special contracts instead of lowering the cost of telephone service. "Illogical" because the gross income may be increased without additional service being rendered. GRONINGER, *op. cit. supra* note 5, 191-200.

⁹ When rates go up as the result of increased wages and cost of materials, the payment to the parent company goes up in proportion. 2 SPURR, *op. cit. supra* note 3, 670-689; Indiana Bell Teleph. Co. v. Public Service Comm. of Indiana *et al.*, 300 Fed. 190 (D. C. Ind. 1924); *In re* Chesapeake & Potomac Teleph. Co. (W. Va.) P. U. R. 1921B, 97; *In re* Chesapeake & Potomac Teleph. Co. (Va.) P. U. R. 1920F, 49; *In re* N. Y. Teleph. Co (N. J.) P. U. R. 1926C, 767.

¹⁰ *In re* Southern Calif. Teleph. Co. (Cal.) P. U. R. 1922C, 97, 123; and *In re* Southern Calif. Teleph. Co., 1925C, 627, 664-667.

¹¹ Pacific Teleph. & Teleg. Co. v. Whitcomb, Director of Public Works (Wash.) P. U. R. 1923D, 113, 125. The 4½% contract said to be "wrong in principle, contrary to public policy, and compensation thereunder should be on a per station basis rather than on a percentage of the gross revenue." This finding was reversed in 12 F. (2d) 279 (W. D. Wash. 1926), and the latter was affirmed in 276 U. S. 97, 48 Sup. Ct. 223, 72 L. ed. 483 (1928). The district court held that the question had been foreclosed by the holding in *Houston v. Southwestern Bell Teleph. Co. and Mo. ex rel Southwestern Bell Teleph. Co. v. Pub. Service Comm.*, both *supra* note 7; Sickler, *Regulation of Public Utility Integration on the Pacific Coast* (1930) 6 J. LAND & PUB. U. ECON., 51, 59-60.

¹² *People ex rel Potter, Atty. Gen. v. Mich. Bell Teleph. Co.*, 246 Mich. 198, 224 N. W. 438 (1929); (1929) 28 MICH. L. REV. 66.

¹³ P. U. R. 1929E 27; *Bulletin of Current Decisions*, No. 3432, of the American Telephone and Telegraph Co., cited by Lilienthal, *Recent Developments in the Law of Public Utility Holding Companies* (1931) 31 COL. L. REV. 189, 199, note 42.

¹⁴ *Mich. Bell Teleph. Co. v. Odell et al.*, 45 F. (2d) 180 (E. D. Mich. 1930). A re-reference of the case was allowed after the decision in the *Smith* case was handed down.

The Equipment Contract with the Affiliated Company.

The Illinois Co. purchased practically all of its equipment from the Western Electric Co., another subsidiary of the American Co. The special three judge district court found that the average net profit of the Western Electric Co. over a period of fourteen years had varied between 7% and 10%. The Supreme Court stated that the finding was of evidentiary value but that it did not go far enough. The Western Electric Co. engaged in a wide field of manufacturing and selling activity, and it cannot be assumed that the net earnings from the entire business represented the net earnings made on the contract with the Illinois Co. Neither would a comparison of the prices charged by the Western Electric Co. to independent telephone companies, nor a comparison of prices charged by other manufacturing companies for comparable material, satisfy the court's holding that there must be findings on the cost of materials sold to the Illinois Co., and the extent to which the profit made by the Western Electric Co. figures in the estimate on which the charge of confiscation by the Illinois Co. was predicated.¹⁵

In *Houston v. Southwestern Bell Telephone Co.*¹⁶ the court allowed charges for materials purchased under a similar contract on the showing by the company that the prices charged were "reasonable and less than the same could be obtained from other sources." A public utility cannot make a rate confiscatory by making improvident contracts with an affiliated corporation.¹⁷ However, contracts between affiliated corporations are presumed valid in the absence of proof of fraud, bad faith, or that the purchasing company is not receiving substantial benefits.¹⁸

Conclusion.

It is submitted that the decision of the *Smith* case must be accepted as: (1) Demanding a more thorough investigation of contracts entered into between local utilities and foreign holding companies and affiliated corporations, in that it establishes that the *cost to the foreign corporations of rendering services to and manufacturing supplies for the local utility* are relevant considerations in determining the reasonableness of payments to such corporations. The

¹⁵ *Smith v. Ill. Bell Teleph. Co.*, *supra* note 107.

¹⁶ *Supra* note 7.

¹⁷ *United Fuel Gas Co. v. Ry. Comm. of Ky.*, 278 U. S. 300, 49 Sup. Ct. 150, 73 L. ed. 390 (1928).

¹⁸ *United Fuel Gas Co. v. Ry. Comm. of Ky.*, *supra* note 17; *Houston v. Southwestern Bell Teleph. Co.*, *supra* note 7.

former decisions appeared to hold that the *market value of services and supplies to the local utilities* was the proper criterion to follow in determining the reasonableness of payments made to parent and affiliated companies.¹⁹ (2) Following the general view, applied in other spheres of intercorporate relationships, that the corporate entity of the local utility will not be disregarded unless fraud or bad faith is demonstrated in its contractual relations, or unless the local utility is relegated to the position of a mere agency or instrumentality of the foreign holding company.²⁰

In order to expedite procedure and relieve the state regulatory bodies of great labor, it has been suggested that the burden of proof of the reasonableness of payments made under intercorporate contracts should be placed on the local utilities. Difficulty would still exist in determining the cost of services and the materials furnished, but the holding and affiliated companies would be anxious to prove the reasonableness of the cost of the services and materials, and they are in a better position to prove them than the state commissions are.²¹

JAMES A. WILLIAMS.

¹⁹ *Houston v. Southwestern Bell Teleph. Co.*; *Mo. ex rel Southwestern Bell Teleph. Co. v. Pub. Service Comm.*, both *supra* note 7; *Lilienthal, op. cit. supra* note 13, 197.

²⁰ *Lilienthal, ibid.*, 194-202.

DISREGARD OF THE CORPORATE FICTION: (1) *Torts*. *Davis v. Alexander*, 269 U. S. 114, 46 Sup. Ct. 34, 70 L. ed. 186 (1925); *Costan v. Manila Elec. Co. et al.*, 24 F. (2d) 383 (C. C. A. 2nd, 1928); *Berkey v. Ry. Co.*, 244 N. Y. 84, 155 N. E. 58 (1926) (recovery not allowed on facts but same rule enunciated); Note (1926) 50 A. L. R. 611 (liability of parent corporations for torts of subsidiaries). (2) *Contracts*. Generally a holding company is not liable on the contracts of a subsidiary unless there is fraud, bad faith, or agency of the subsidiary in which the holding company rather than the subsidiary reaps the benefit. *Pa. Canal Co. et al. v. Brown et al.*, 235 Fed. 669 (C. C. A. 3rd, 1916) (*Certiorari* denied, 242 U. S. 646, 37 Sup. Ct. 240, 61 L. ed. 543 (1917)); *Ambridge v. Philadelphia Co.*, 283 Pa. 5, 129 Atl. 167 (1925); Note (1925) 39 A. L. R. 1071; *Kingston Dry Dock Co. v. Lake Champlain Trans. Co.*, 31 F. (2d) 265 (C. C. A. 2nd, 1929) (recovery denied but court uses same language as employed in tort cases); *Majestic Co. v. Orpheum Circuit*, 21 F. (2d) 720 (C. C. A. 8th, 1927); 3 COOK, CORPORATIONS (8th ed. 1923) §§663-664, 2578-2590. (3) *Statutory evasion*. *Southern Pac. Terminal Co. v. Interstate Commerce Comm. and Young*, 219 U. S. 498, 31 Sup. Ct. 279, 55 L. ed. 310 (1910) (unlawful preference); *U. S. v. Lehigh Valley Ry. Co.*, 220 U. S. 257, 31 Sup. Ct. 387, 55 L. ed. 458 (1911) (violation commodities clause); *U. S. v. Delaware, L. & Ry. Co.*, 238 U. S. 516, 35 Sup. Ct. 873, 59 L. ed. 1430 (1915).

²¹ *Lilienthal, op. cit., supra* note 13, 205; *Sickler, op. cit. supra* note 11, 64.