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Authors
Bank, Steven A
Cheffins, Brian R

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The Corporate Pyramid Fable (Revised)

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Steven A. Bank and Brian R. Cheffins

The Corporate Pyramid Fable

Although corporate pyramids are currently commonplace world-wide and although there have been "noteworthy pyramiders" in American business history, this controversial form of corporate organization is now a rarity in the United States. The conventional wisdom is that corporate pyramids disappeared in the U.S. when New Deal policymakers began taxing dividends paid to corporate shareholders. This version of events is more fable than truth. The introduction of the intercorporate dividend tax did not foster a rapid dismantling of corporate pyramids. Instead, pyramidal arrangements were already rare in the U.S., other than in the utilities sector, and the demise of utility pyramids was prompted by the Public Utilities Holding Company Act of 1935 rather than by tax reform.

In his 1935 book *The Lords of Creation*, Fredrick Lewis Allen analyzed the corporate and financial trends that shaped the development of the U.S. economy from the 1890s to the Depression. Of corporate pyramids he wrote, "If it had not been for the lavish use of this logical extension of the holding-company device, many of the giants of the economic world would never have got their growth."[1] According to Allen, "noteworthy pyramiders" of the era included utilities magnate Samuel Insull and railroad financiers Oris Paxton Van Sweringen and Mantis James Van Sweringen. In *The Modern Corporation and Private Property* (1932), Adolf Berle and Gardiner Means said of the Van Sweringen organization, "By this pyramid an investment of less than twenty million dollars has been able to control eight Class I railroads having

STEVEN A. BANK is professor of law at the UCLA School of Law.

BRIAN R. CHEFFINS is S. J. Berwin Professor of Corporate Law at the Faculty of Law at the University of Cambridge.

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[1] Fredrick Lewis Allen, *The Lords of Creation* (New York, 1935), 248.

Business History Review 84 (Autumn 2010): 435–458. © 2010 by The President and Fellows of Harvard College.

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combined assets of over two billion dollars."[2] According to Berle and Means, the Van Sweringens' business practices exemplified an important business trend. They said that among various legal devices available to ensure control of a corporation without ownership of a majority of the voting shares, "the most important among the very large companies is the device of 'pyramiding.'"[3]

While Allen and Berle and Means were convinced of the importance of corporate pyramids, this form of corporate organization has been neglected from a historical perspective, at least in the U.S. context.[4] Henrietta Larson, in a 1947 survey of business history, said of the large holding company group, a form of corporate organization of which the pyramid is a subset, that there was "a need and an opportunity for research that cannot be stressed too greatly."[5] This challenge was not taken up, and historical work on U.S. corporate pyramids was generally restricted to studies of Insull and the Van Sweringen brothers and research by economist Randall Morck.[6]

In a sense it is unsurprising that corporate pyramids in America have failed to generate substantial historical analysis since they are now very much a side-show in the U.S. corporate landscape. Morck and fellow economist Bernard 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."[7] Belen Villalonga and Raphael Amit confirm this point in a 2009 article on family control of major public companies, in which they report that of the 40 percent of Fortune 500 companies that are founder- or family-controlled, only 5 percent of founders or families use pyramids to help ensure that their control rights exceed their cash-flow rights.[8]

As Morck and Yeung imply, the rarity of corporate pyramids leaves the U.S. as something of an outlier. In numerous countries, companies

[2] See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New Brunswick, N.J., 1997, originally published in 1932), 69.

[3] Ibid., 72.

[4] There has been some historical research done on pyramids elsewhere. See, for example, Randall K. Morck and Masao Nakamura, "Business Groups and the Big Push: Meiji Japan's Mass Privatization and Subsequent Growth," *Enterprise & Society* 8 (2007): 543.

[5] Henrietta M. Larson, "Business History: Retrospect and Prospect," *Bulletin of the Business Historical Society* 21 (1947): 173, 195.

[6] Forrest McDonald, *Insull* (Chicago, 1962); Herbert H. Harwood, *Invisible Giants: The Empires of Cleveland's Van Sweringen Brothers* (Bloomington, 2003); Randall Morck, "The Riddle of the Great Pyramids," National Bureau of Economic Research Working Paper No. 14858 (2009), 14.

[7] Randall Morck and Bernard Yeung, "Dividend Taxation and Corporate Governance," *Journal of Economic Perspectives* 19 (2005): 163, 174, 177; see also Morck, "The Riddle of the Great Pyramids," 3.

[8] Bellen Villalonga and Raphael Amit, "How Are U.S. Family Firms Controlled?" *Review of Finance* 22 (2009): 3047, 3062–63, 3075–76.

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are frequently part of wider business groups controlled by wealthy families or successful entrepreneurs.[9] Those at the apex of such groups often exercise greater corporate clout than they have paid for, in the sense that the assets under their control substantially exceed their financial stake. The individual or family in charge achieves control through a chain of ownership relations 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 a pyramidal structure. Data compiled by economists Ronald Masulis, Peter Pham, and Jason Zein confirm that corporate pyramids are much more common globally than they are in the United States, reporting that, as of 2002, only 0.91 percent of all U.S. public companies were controlled through a pyramidal structure, the second lowest figure among the forty-five countries they examined for the purposes of a study of family business groups and corporate pyramids.[10]

For successful entrepreneurs or wealthy families, using a corporate pyramid permits them to diversify risk and to move into promising new economic sectors with a limited capital investment. Investors, for their part, can seek to ride the coattails of success by buying shares in companies affiliated with a successful corporate group.[11] Still, the dearth of corporate pyramids might be a salutary feature of the U.S. corporate landscape. Corporate pyramids provide opportunities for those at the apex 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. Business groups of this type have also 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."[12] Moreover, purportedly "pyramidal control can disguise market power, frustrate tax authorities and manipulate government."[13]

While corporate pyramids in global terms are an important business form and while their pros and cons are well known, no formal theory explains the presence or absence of this important and controversial

[9] "Pharaoh Capitalism," *Economist*, 14 Feb. 2009, 90; Heitor V. Almedia and Daniel Wolfenzon, "A Theory of Pyramidal Ownership and Family Business Groups," *Journal of Finance* 61 (2006): 2637.

[10] Ronald W. Masulis, Peter Kien Pham, and Jason Zein, "Pyramids: Empirical Evidence on the Costs and Benefits of Family Business Groups around the World," European Corporate Governance Institute Finance Working Paper No. 240 (2009), 8, Table II.

[11] Ibid., 3.

[12] Randall Morck, "How to Eliminate Pyramidal Business Groups: The Double Taxation of Intercorporate Dividends and Other Incisive Uses of Tax Policy," in *Tax Policy and the Economy*, 19th ed., ed. James M. Poterba (Cambridge, Mass., 2005), 135, 136.

[13] Morck, "The Riddle of the Great Pyramids," 17.

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business form either in historical or cross-country terms.[14] Recently, however, an emerging consensus has developed that points to the tax treatment of dividends received by corporate shareholders to explain the special position of the United States. Specifically, taxation of intercorporate dividends—imposed during the New Deal and remaining in place today—prompted pyramids then in existence to crumble and precluded new pyramidal structures from forming. This explanation is not merely a matter of historical interest. For policymakers in countries where corporate pyramids are prevalent and constitute a source of concern, the U.S. experience seemingly offers a strong normative message —the tax code can be used to correct matters. For instance, the Bank of Israel in its 2009 annual report identified the taxation of intercorporate dividends as a potential solution to the pyramidal structure of ownership in the Israeli economy, specifically citing developments in the U.S. in the 1930s.[15]

This paper investigates the thesis that the introduction of intercorporate taxation of dividends accounts for the rarity of corporate pyramids in the U.S. and finds it wanting. Among those companies that had publicly traded securities and had, according to filings with the federal Securities and Exchange Commission (SEC), corporate shareholders owning stakes of 10 percent or larger, the introduction of intercorporate taxation of dividends did little to prompt the collapse of those corporate pyramids that did exist. The likely explanation is that the tax "hit" was insufficiently large to elicit major changes. Moreover, the available evidence indicates that, the utility sector excepted, corporate pyramids were not a hallmark of U.S. corporate governance prior to the introduction of intercorporate taxation of dividends in 1935. Correspondingly, even radical tax reform would not have prompted wholesale changes. In short, the tax explanation for the demise of corporate pyramids is more fable than truth. It is premature to tender definitive substitute explanations for the dearth of corporate pyramids in the U.S., but the paper concludes by offering plausible conjectures.

The Received Wisdom on Corporate Pyramids and Intercorporate Taxation of Dividends

In most countries other than the United States, intercorporate dividends are fully deductible for tax purposes when the recipient is a corporation that owns a prescribed minimum percentage of shares of the corporation paying the dividend. In Canada, for instance, the dispensation

[14] Almeida and Wolfenzon, "Theory," 2638.
[15] Bank of Israel, *Annual Report, 2009* (Jerusalem, 2010), 174.

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is available so long as the ownership stake is 10 percent or more.[16] The path the U.S. took in departing from the global norm concerning the taxation of intercorporate dividends began in 1913 when such payments were subjected to full taxation after the Sixteenth Amendment established the federal income tax.[17] An increase in the corporate income tax rate from 2 percent to 6 percent in the years that followed meant this feature of tax law began to generate serious objections, and in response, Congress in 1918 permitted corporations to, in effect, exempt fully from their taxable income dividends received from subsidiary corporations.[18] This tax regime therefore matched the current pattern in Canada and other countries.

Conditions changed again in 1935, when the full tax exemption for intercorporate dividends was replaced by a 90 percent exemption, which was lowered to 85 percent in 1936. These alterations resulted in an effective tax rate of 2.25 percent on dividends received by corporate stockholders, given the prevailing rate of taxation on corporate income of 15 percent on income in excess of $40,000, rising to 2.5 percent for the 1938–1939 fiscal year, when the tax rate for corporate income was increased to 16 percent. A similar large but partial exemption remains in place today.[19]

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 that New Dealers launched the tax in large measure 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."[20] According to Morck, matters went exactly according to plan. He argues that the taxation of intercorporate dividends "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."[21]

The targeting of corporate pyramids, Morck argues, was sound public policy. He maintains that pyramids concentrate corporate control counterproductively in the hands of wealthy individuals or families,

[16] Morck, "How to Eliminate Pyramidal Business Groups," 145.

[17] George Mundstock, "Taxation of Intercorporate Dividends under an Unintegrated Regime," *Tax Law Review* 44 (1988): 1, 7.

[18] "Seligman Reports on War Finances," *New York Times*, 28 Dec. 1918, 14.

[19] Internal Revenue Code § 243 (1996) (70 percent exemption if the corporation receiving the dividends has an ownership stake of less than 20 percent, 80 percent for ownership stakes from 20 percent to 80 percent, and 100 percent for ownership stakes of 80 percent or more).

[20] Morck, "How to Eliminate Pyramidal Business Groups," 152.

[21] Ibid., 168.

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and says that due to the wisdom of New Deal policymakers the United States rid itself of this particular corporate governance affliction. According to Morck, "The New Dealers were sweepingly successful for business groups all but disappeared from the U.S. corporate landscape."[22] Moreover, ongoing taxation of intercorporate dividends foreclosed any back-tracking. As Morck and Yeung have written 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."[23]

This conclusion stands in tension with contemporary views on the subject. 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 in a 1941 report on corporate taxation that taxation of incorporate dividends was in fact little more than a sideshow. According to the TNEC, 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."[24]

Notwithstanding the TNEC study, the theory that intercorporate dividend taxation explains the dearth of corporate pyramids in the U.S. now amounts to the received wisdom. Law professor Mark Roe argued in his 1994 book *Strong Managers, Weak Owners* that the introduction of taxation of intercorporate dividends deterred companies from holding large ownership blocks in other companies, reasoning that only rarely would returns from such an investment be sufficient to compensate for the tax penalty on dividends paid out.[25] More recently, economists Tarun Khanna and Yishay Yafeh specifically endorsed Morck's analysis of history in a 2007 survey of the literature on corporate pyramids, indicating that "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."[26] Villalonga and Amit concur, writing in their 2009 article on family control of major U.S. public companies that their finding that pyramids are rarely used is consistent with Morck's argument "that pyramidal business groups largely disappeared from the United States

[22] Ibid., 164.

[23] Morck and Yeung, "Dividend Taxation and Corporate Governance," 174.

[24] Temporary National Economic Committee, *Taxation of Corporate Enterprise* (Washington, D.C., 1941), 59, 63.

[25] Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, N.J., 1994), 107–8.

[26] Tarun Khanna and Yishay Yafeh, "Business Groups in Emerging Markets: Paragons or Parasites?" *Journal of Economic Literature* 45 (2007): 331, 341.

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in the 1930s as a result of intercorporate dividend taxation and other tax reforms that rendered them prohibitively costly."[27]

The conjecture that corporate pyramids disappeared in the U.S. because of taxation of intercorporate dividends is not backed by hard data. The only empirical evidence Morck advances to support his argument that tax reform caused the disappearance of corporate pyramids in the U.S. arises from a 1937 study conducted by the Twentieth Century Fund on tax reforms instituted during the New Deal.[28] The study identified thirty major U.S. corporations that had recently eliminated holding company structures and Morck argues the corporate restructuring constituted evidence of "the rapid dissolution of the pyramidal groups in the United States."[29] In fact, the Twentieth Century Fund study provides little direct guidance on a possible connection between taxation and the dismantling of pyramids.

While Morck treats the consolidation engaged in by the thirty companies cited in the Twentieth Century Fund study as proof of the dismantling of corporate pyramids, the study itself does not indicate whether these firms were part of pyramidal corporate structures. The available evidence—Moody's trade manuals, newspaper stories, and annual reports to shareholders—indicates that only seven companies were involved in a corporate group where the corporation at the apex held stakes in publicly-traded companies and owned enough shares to exercise at least *de facto* control. Two of the seven companies, Atlas Corporation and Electric Bond and Share Company, constituted the top tier of a corporate pyramid, as they held partial stakes in a significant number of publicly-traded subsidiaries and lacked a dominant corporate shareholder themselves.[30] Of the five other companies, Central Power and Light and Central Maine Power were part of the corporate empire of utilities magnate Samuel Insull. Electric Power and Light, International Hydro-Electric, and Northern New York Utilities were affiliated with utility pyramids focused on the Electric Bond and Share group, International Paper and Power Co., and the United Corporation group, respectively.

[27] Villalonga and Amit, "How Are U.S. Family Firms Controlled?" 3075.

[28] Morck, "How to Eliminate Pyramidal Business Groups," 153, discussing Twentieth Century Fund, Committee on Taxation, *Facing the Tax Problem* (New York, 1937).

[29] Morck, "How to Eliminate Pyramidal Business Groups," 153.

[30] Moody's Corp., *Moody's Manual of Investments, American and Foreign; Banks, Insurance Companies, Investment Trusts, Real Estate, Finance and Credit Companies* (New York, 1935), 2009; "Atlas Corp. Head Traces Acquisitions of Other Trusts," *Wall Street Journal*, 30 June 1937, 3; Moody's Corp., *Moody's Manual of Investments, American and Foreign Public Utility Securities* (New York, 1935), 1405 (Electric Bond & Share). General Electric, which founded Electric Bond and Share, exited in 1924: James C. Bonbright and Gardiner C. Means, *The Holding Company: Its Public Significance and Its Regulation* (New York, 1932), 106.

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Among these seven companies the introduction of intercorporate taxation of dividends does not appear to have been the catalyst for the reorganizations in which they were engaged. Central Power and Light's and Northern New York Utilities' consolidations were apparently motivated by efficiency concerns rather than tax issues.[31] In the cases of Electric Power and Light and Atlas, the reorganization process began before the introduction of intercorporate taxation of dividends in 1935. Electric Power and Light started its consolidation program in 1930, and Atlas began simplifying its overall capital structure in the early 1930s, immediately after it had acquired dominant stakes in nearly twenty-five investment companies trading at distressed prices due to the 1929 stock market crash.[32]

The Public Utility Holding Company Act of 1935 (PUHCA), a legislative measure designed to simplify the corporate structure of the utilities industry, was apparently the major agent of change.[33] Electric Bond and Share responded to enactment of PUHCA by reducing its holdings in all utility companies below a 5 percent "affiliate" threshold set in the legislation, save for six former "client" holding companies.[34] 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 PUHCA.[35] Likewise, when Central Maine Power transferred all of the properties of its subsidiaries to itself in October 1935, its plan was to become a pure operating company and thereby avoid holding-company status under PUHCA.[36] Thus, the empirical evidence that Morck advances to support his thesis that the introduction of intercorporate taxation of dividends accounts for the demise of the corporate pyramid in the U.S. is far from dispositive.

[31] In 1935 Central Power and Light dissolved two subsidiaries that had recently transferred away their assets. See Moody's Corp., *Moody's Manual of Investments, American and Foreign Public Utility Securities*, 638. Northern New York Utilities, which was intended to be the survivor of a consolidation of a utility group organized around the Niagara Hudson Power Corporation, cited in its application to the New York Public Service Commission for regulatory approval "the elimination of the necessity for maintaining such separate records and the economies in operation by the consolidated company." See "Stockholders Back Merger of Utility," *New York Times*, 22 Jan. 1936, 31. The Commission rejected the application: "Merger Plan Withdrawn," *New York Times*, 15 Aug. 1936, 20.

[32] Moody's Corp., *Moody's Manual of Investments, American and Foreign Public Utility Securities*, 1432; Electric Power & Light Corporation, *Annual Report* (1937), 4. "Atlas Securities Would Merge Units", *New York Times*, 10 June 1932, 29; "Atlas Expansion Near Completion," *Wall Street Journal*, 11 June 1932, 7; "Atlas Corp. Proposes Final Step to Complete Consolidation Plan," *Wall Street Journal*, 29 Sept. 1936, 3.

[33] 49 Stat. 803.

[34] "Investments Cut by Bond and Share," *New York Times*, 6 Dec. 1935, 39.

[35] Utility Act Forces a Huge Divestment," *New York Times*, 2 Dec. 1935, 31.

[36] "Central Maine Power Classified as Strictly Operating Unit Now," *Wall Street Journal*, 4 Oct. 1935, 6.

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Securities and Exchange Commission Data on Corporate Ownership, 1936–38

The received wisdom on intercorporate taxation of dividends and corporate pyramids implies that corporate stockholding in publicly-traded companies should have declined significantly after the tax on intercorporate dividends was introduced. To the extent that this hypothesis is correct, the introduction of taxation on intercorporate dividends in 1935 should have fostered the prompt sell-off of corporate-held ownership blocks in public companies, thus causing the simplification of complex group structures, including pyramids. As Morck says, "The 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."[37]

The only data available to test on a firm-level basis the hypothesis that the introduction of intercorporate taxation of dividends prompted the unwinding of corporate pyramids are filings made with federal securities regulators. Under section 16(a) of the Securities and Exchange Act of 1934, as originally enacted, an owner of 10 percent 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.[38] Filings by shareholders owning 10 percent or more of a company's stock are publicly available back to the end of 1935, and relevant subsequent changes are reported on a month-by-month basis.

We examined SEC filings to compile a data set of corporate stockholders extending from the beginning of 1936 to the end of 1938. Our departure point was a 1936 volume the SEC prepared that detailed shareholdings exceeding 10 percent for the 1,736 corporations registered with it as of the end of 1935, as well as all shareholdings of directors and officers.[39] These "insiders" collectively owned approximately 21 percent 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 percent of all public shares outstanding.[40] Of the 1,736 issuers, 331 (18.9 percent) had a

[37] Morck, "How to Eliminate Pyramidal Business Groups," 136.

[38] 48 Stat. 881.

[39] Securities and Exchange Commission, *Official Summary of Holdings of Officers, Directors, and Principal Stockholders: As Reported to the Commission on Forms 4, 5, and 6, Pursuant to Section 16 of the Securities Exchange Act of 1934, as of December 31, 1935* (Washington, D.C., 1936).

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

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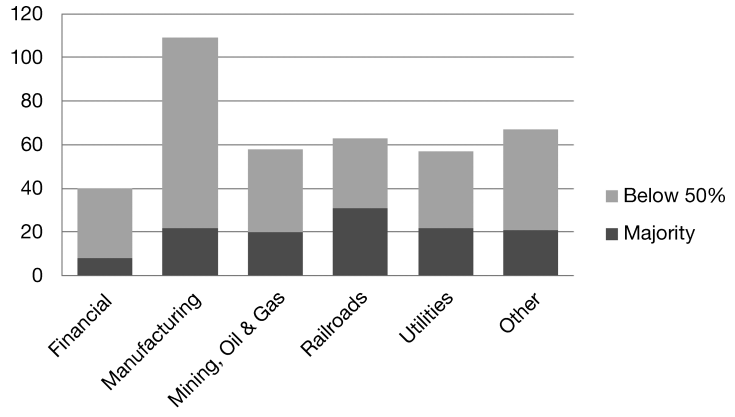

Figure 1. Holdings of 10 percent or more, categorized by industrial sector, sub-categorized by minority vs. majority ownership. (Source: Compiled from SEC, *Official Summary*.)

corporate shareholder owning 10 percent or more of the common shares. There were 424 instances in which a corporation was a holder of 10 percent or more of common stock, with 261 corporations owning these 424 stakes.[41] Of the 394 of the 424 holdings for which the precise size of the stake could be ascertained, there was majority ownership in 123 instances. Majority stakes were considerably more prevalent than the norm in the railway sector and considerably less prevalent among firms operating in the manufacturing sector, the largest sector overall, as well as among financial companies (see Figure 1).

Morck claims that corporate pyramids experienced "rapid dismantling" after the introduction of intercorporate taxation of dividends.[42] If this occurred, a large number of corporations with stakes of 10 percent or more in companies registered with the SEC should have sold out completely or at least reduced their holdings substantially over the ensuing few years.[43] A sizeable proportion of companies might have maintained their shareholdings during this period, but increases should have been extremely rare. A search of monthly SEC filings for 1936, 1937, and 1938 indicates a rather different pattern.

[41] The total was higher once preferred shares were taken into account. See Frank P. Smith, *Management Trading: Stock Market Prices and Profits* (New Haven, 1941), 73, Table II (abstracting data from Table I of the materials prepared to support Securities Exchange Act Release No. 989).

[42] Morck, "How to Eliminate Pyramidal Business Groups," 168.

[43] Theoretically, the selling off of corporate stakes induced by the introduction of taxation of intercorporate dividends could have taken longer than just a few years as a result of inertia or transactions costs, but this sort of postponed effect seems unlikely due to the economic dislocation associated with the start of World War II.

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Of the 424 corporate holdings of common stock of 10 percent or more listed by the SEC for the end of 1935, throughout 1936–1938 there were only forty instances in which the corporate stockholder sold off a sufficiently large number of shares to indicate that disclosure was no longer required under SEC rules. Moreover, reductions in the size of the stake held in circumstances where the corporate stockholder continued to be a 10 percent "insider" were not particularly common, occurring on fifty occasions in 1936, twenty-three in 1937, and fifteen in 1938. The fact that share disposals were most pronounced in 1936 could imply some short-term reaction to tax reform. However, even in 1936 the most common scenario was the status quo, with 79.7 percent of corporate-held stakes of 10 percent or more remaining unchanged, as compared to 84.1 percent in 1937 and 88.2 percent in 1938.

The received wisdom on intercorporate taxation of dividends implies that on the occasions where a 10 percent corporate "insider" changed the size of its holding, the corporation would, absent special circumstances, be selling shares. There were, however, numerous instances in which corporate stockholders accumulated additional shares: twenty-four in 1936, thirty in 1937, and eighteen in 1938. Correspondingly, the ratio of increases to decreases, including instances in which the sale of shares was large enough to mean disclosure was no longer required, was 24:62 in 1936, 30:36 in 1937, and 18:30 in 1938. Given this pattern, and given that our analysis of SEC filings did not take into account instances in which a corporation in these years acquired afresh a sufficiently large stake in an issuer to require "insider" disclosure with the SEC, our data confirm the findings of economist Frank Smith in a 1941 study on insider trading. He examined share dealing by corporations holding 10 percent or more of a firm's shares and determined that, between January 1936 and June 1938, "the purchases and sales of corporations almost balanced."[44] Intercorporate taxation of dividends therefore did not prompt the "rapid dismantling of American business groups."

Explaining Why Intercorporate Taxation of Dividends Failed to Prompt Major Changes

Bearing in mind the role dividends played in U.S. corporate life during the 1930s, the fact that the introduction of intercorporate taxation of dividends failed to displace corporate ownership of shares to a sizeable extent seems surprising. 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

[44] Smith, *Management Trading*, 101–2.

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as dividends and strongly resisted reducing dividend payouts.[45] Adherence to the policy of maintaining the dividend was so strong that during the 1930s there were a number of years, including 1938, in which aggregate dividend payouts actually exceeded reported earnings among major U.S. public companies.[46] Since dividends were accorded such a high priority by corporations and the investment community, exit would seem to have been a natural reaction when dividends received by corporate stockholders were subject to a new tax penalty.

The most likely explanation for why the introduction of intercorporate taxation of dividends did little to induce corporations owning shares in publicly-traded firms to sell off their holdings is that the effective tax rate of 2.25 percent on dividends was not a large tax "hit." The TNEC made precisely this point, arguing that the mild character of the new tax on intercorporate dividends explained why reform failed to have an appreciable impact on U.S. corporations.[47] While, as the TNEC pointed out, intercorporate dividends were "a very substantial part of all cash dividends paid out by American corporations" during the mid-1930s, during 1937 intercorporate taxation of dividends amounted to only 0.57 percent of net profits for all corporations and 0.92 percent for companies with assets of $100 million or more.[48] Since the taxation of intercorporate dividends did not make a major dent in the corporate "bottom line," corporations lacked a compelling tax reason to offload rapidly their ownership stakes in publicly-traded firms.

Other potential explanations for why the introduction of intercorporate dividend taxation failed to prompt a rapid dismantling of corporate ownership of blocks of shares in public companies are unpersuasive. Conceivably, for instance, companies seeking to distribute cash to their corporate shareholders could have used share buybacks as a substitute for dividends, meaning corporate blockholders would have been under little pressure to sell their holdings. In fact, 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

[45] Jonathan Barron Baskin and Paul J. Miranti, *A History of Corporate Finance* (Cambridge, U.K., 1997), 22, 195, 233; Donald E. Wilbur, "A Study of the Policy of Dividend Stabilization," *Harvard Business Review* 10 (1932): 373.

[46] Jack W. Wilson and Charles P. Jones, "An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870–1999," *Journal of Business* 75 (2002): 505, 529 (see figures listed under payout percent).

[47] Temporary National Economic Committee, *Taxation*, 60.

[48] Ibid., 40; Bureau for Internal Revenue, *Statistics of Income for 1937, Part 2: Compiled from Corporation Income and Excess-Profits Tax Returns and Personal Holding Company Returns* (Washington, D.C., 1940), Table 5, 82–83. The amount of the tax on intercorporate dividends can be ascertained from Table 5 by calculating 15 percent of the figure in line 24 and multiplying by 0.15, the corporate tax rate in 1937.

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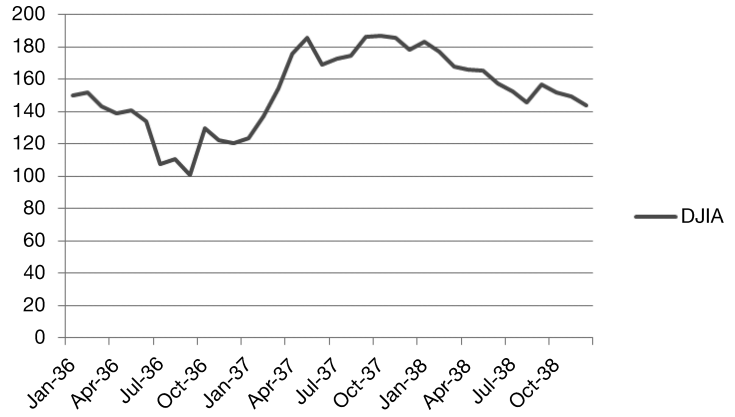

Figure 2. Share prices, 1936–38 (Dow Jones Industrial Average, prices at the beginning of each month). (Source: Derived from Yahoo! Finance.)

about violating prohibitions against manipulation of security prices in the Securities Exchange Act passed that year.[49] From then until at least the 1960s, the repurchasing of shares was viewed not as a means for distributing cash to shareholders but rather as a defensive device to be used to counteract dilution created by acquisitions, employee stock-purchase programs, and stock option plans.[50]

Another possible explanation for the predominance of the status quo is that market conditions may have deterred exit, at least temporarily. In the bear market that characterized the 1930s, corporations owning shares in other firms may have been reluctant to sell at a loss despite the introduction of intercorporate taxation of dividends. However, while share prices dipped sharply in 1936 (see Figure 2), shares performed reasonably well during the remainder of 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. Given these market conditions, given that dividends were an important feature of 1930s capital markets, and given that share repurchases did not provide a realistic means to distribute cash to stockholders, the modest rate at which dividends received by corporations were taxed is the most plausible explanation for why the change to the law did not dislodge markedly corporate ownership of shares in public companies.

[49] "Finance, Business, Economics," *Washington Post*, 26 Dec. 1934, 18.

[50] Charles D. Ellis, "Repurchase Stock to Revitalize Equity," *Harvard Business Review* 43 (1965): 119 (urging companies to change their approach).

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Were Corporate Pyramids Ever a Prominent Feature of the U.S. Corporate Landscape?

When Morck claims that 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 writes, "Pyramidal corporate groups were introduced to the United States in 1889 and became commonplace by the 1920s."[51] To the extent this is correct, it is logical to search for a moment or event that resulted in their disappearance. Our empirical findings indicate that the introduction of intercorporate taxation of dividends was not such an event. 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 that, with the exception of the utility sector, they in fact were not.

Until the introduction of federal securities law in the mid-1930s, corporations and their stockholders were not compelled to disclose the sort of ownership data they relied on for the purposes of this study. Correspondingly, there is a dearth of empirical evidence on earlier ownership patterns in U.S. public companies. Research done by economist Gardiner Means is 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.[52] Means's research was a core element of *The Modern Corporation and Private Property* and also featured prominently in *The Holding Company*, a 1932 volume co-written with James Bonbright.[53]

To put Means's data 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.[54] This sort of firm is often referred to as a parent company. A parent

[51] Morck, "How to Eliminate Pyramidal Business Groups," 148.

[52] Berle and Means, *The Modern Corporation*, 84–85, Table XIII; Brian Cheffins and Steven Bank, "Is Berle and Means Really a Myth?" *Business History Review* 83 (Autumn 2009): 443, 453.

[53] Berle and Means, *The Modern Corporation*. Their data on ownership and control drew heavily from Gardiner C. Means, "The Separation of Ownership and Control in American Industry," *Quarterly Journal of Economics* 46 (1931): 68.

[54] Morck, "How to Eliminate Pyramidal Business Groups," 138, 143.

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company can be 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 wholly rather than directly by the company itself.

If a parent company lacks any operating aspect, in the sense that it does not make, sell, or distribute a commodity or offer a service, it can be categorized more appropriately as a "pure" holding company.[55] A cousin to the pure holding company is the investment company, which also is unlikely to have any operating-company aspect. However, while most, if not all, of the assets of investment companies, other than cash and its equivalents, will be in the form of publicly-traded securities such as stocks, holding companies will frequently have only wholly-owned subsidiaries and few will have stakes in a wide-ranging portfolio of public companies.[56] Moreover, a holding company, unlike an investment company, will usually do more than simply "hold" the shares and instead will likely exercise some form of control over the companies in which it owns shares.[57] Hence, a "holding company occupies a position midway between a mere investing organization and one absolutely controlling the activities of other corporate enterprises."[58]

In corporate pyramids, the corporation at the apex will likely resemble a holding company, doing no more than providing marketing services, technical advice, and general overall direction to lower-tier companies. This rule is by no means hard and fast; the corporation in question 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 at the apex will own shares in companies that have outside investors.[59] Outside investment is a pre-requisite because it permits the family, entrepreneur, or executives who are ultimately in charge to have corporate reach that exceeds the underlying financial stake. The corporation at the apex will need to own enough shares in the publicly-traded companies in the second tier of the pyramid

[55] Charles S. Tippetts and Shaw Livermore, *Business Organization and Control*, 2nd ed. (New York, 1940), 168.

[56] See Securities and Exchange Commission, *Report on the Study of Investment Trusts and Investment Companies, Part One: Origin, Scope and Conduct of the Study* (Washington, D.C., 1939), 25 (distinguishing "investment companies proper" from an investment company/holding company hybrid the SEC labeled "management-investment holding companies").

[57] Bonbright and Means, *The Holding Company*, 8–10, 12–14.

[58] G. Lloyd Wilson, "Book Review," *Annals of the American Academy of Political and Social Science* 165 (1933): 236.

[59] In the literature on pyramids, it is widely assumed that the outside investors will be shareholders in a publicly traded company, though theoretically a pyramid could exist without the relevant companies being traded on a stock market. See Villalonga and Amit, "How Are U.S. Family Firms Controlled?" 3060.

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to dictate the outcome of director elections but will not necessarily need a 50 percent stake because many small shareholders will not vote.[60] The companies in the second layer of the pyramid can then hold similar blocks in publicly-traded companies in the third tier and so on, thus permitting, as Berle and Means said in *The Modern Corporation and Private Property*, "the owner of a majority of the stock of the company at the apex of a pyramid (to) have almost complete control of the entire property as sole owners even though his ownership interest is less than one percent of the whole."[61]

Berle and Means's data on the ownership structure of the largest two hundred non-financial corporations in the U.S. as of 1929 indicates that, in the industrial sector, pyramidal arrangements were the exception to the rule. Only 10 (9.4 percent) of the 106 industrial enterprises in their sample had pyramidal ownership features: prominent examples included General Motors, in which E. I. du Pont de Nemours & Co. owned 33 percent of the shares; Goodyear Tire, in which Cleveland financier Cyrus Eaton and his associates held a 28 percent stake; and Loew's Inc., an amusement company focusing on motion pictures, in which General Theatres Equipment Inc. was a 49-percent stockholder.[62] Bonbright and Means's study reveals a similar pattern. They found that among the ninety-seven largest industrial corporations in 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 ninety-three, seventy-two were parent companies, meaning they had a significant operating aspect, and the vast majority of these (fifty-nine) were primarily operating companies.[63] With these parent companies, their subsidiary companies were apparently usually wholly-owned, or close to it. As Bonbright and Means wrote, over a period of years there had been a "definite tendency for the industrial company to acquire all, or practically all, of the stock of its subsidiaries."[64]

[60] Some researchers do argue that a stake of 50 percent is required for control, but it is commonly assumed that a smaller stake will suffice (e.g. 20 percent). On this point, see Morck, "The Riddle of the Great Pyramids," 2; Marc Levy, "Control in Pyramidal Structures," *Corporate Governance: An International Review* 17 (2009): 77, 78–79, 81, 87.

[61] Berle and Means, *The Modern Corporation* 69.

[62] Compiled from ibid., Table XIII. Berle and Means's 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 whether ultimate control was achieved by pyramiding or was of a different sort. Compiled from Berle and Means, *The Modern Corporation*, Table XIII; on the particular companies see 93–94.

[63] Bonbright and Means, *The Holding Company*, 77.

[64] Ibid., 79; see also "Holding Firm Abuse Mostly in Utility Field," *Chicago Daily Tribune*, 30 Jan. 1938, B5.

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Among Bonbright and Means's industrial cohort, the remaining twenty-one of the ninety-seven 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 twenty-one it appears that corporate pyramids were the exception to the rule. Bonbright and Means reported that fifteen had insignificant minority interests in other corporations. Of the remaining six companies, only two—Tobacco Products Corporation, controller of United Cigar Stores Company, and Union Oil Associates, 57-percent owner of the Union Oil Company of California—adopted a pyramid-style practice of holding less than the maximum stock interest that they could obtain under the circumstances.[65] Bonbright and Means correspondingly asserted that, among the twenty-one companies and major industrial companies generally, there was "relatively little indication that pyramiding is resorted to as a permanent policy in the industrial field."[66]

The pattern was similar with railways. A 1932 text on business organizations observed that "among railroads it [the holding company device] has attracted attention only in special cases."[67] Of the forty-two railway companies in Berle and Means's list of the two hundred largest non-financial companies, only seven (16.7 percent) were identified as having pyramidal ownership features.[68] Similarly, Bonbright and Means reported that as of 1930 only 19 percent of all railway mileage was under the ultimate control of companies most likely to be at the apex of a corporate pyramid, namely those lacking a significant operating aspect, and Bonbright and Means labelled these firms pure holding companies, not pyramids.[69]

Financial companies constituted a significant gap in Means's empirical work. The available evidence indicates, however, that pyramids were very much the exception among a key type of financial firm where pyramidal structures might be expected to prevail. With the Investment Company Act of 1940, which was designed primarily to regulate "investment trusts" ("managed" investment companies in which the managers in charge had discretion to buy and sell the securities held rather than simply administering a fixed portfolio), section 12(d) ostensibly attacked pyramiding of investment companies by forbidding an investment company from owning more than 5 percent of the shares of

[65] Bonbright and Means, *The Holding Company*, 81–82.
[66] Ibid., 80; see also 87.
[67] Charles S. Tippetts and Shaw Livermore, *Business Organization and Control: Corporations and Trusts in the United States* (New York, 1932), 229.
[68] Compiled from Berle and Means, *The Modern Corporation*, Table XIII.
[69] Bonbright and Means, *The Holding Company*, 227–28.

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another investment company.[70] However, an SEC analysis of ownership patterns in 122 major investment trusts undertaken as part of a four-year investigation of the investment-company industry indicated that as of 1938 there were only twenty-two instances in which an investment trust owned 10 percent or more of the shares of another investment trust.[71] Moreover, of the seventeen different "underlying" investment trusts owning these twenty-two stakes, in only five instances did an investment company own in full-blown pyramid-style a stake of 10 percent or more in one of these seventeen firms.[72]

The fact that pyramidal structures were the exception to the rule among investment companies helps to put into context an aspect of our SEC corporate ownership data and reinforces the point that the introduction of intercorporate taxation of dividends was not a catalyst for widespread dismantling of corporate pyramids. In only forty of the 424 instances (9.4 percent) where a corporation disclosed to the SEC in 1935 an ownership stake of 10 percent or more was the issuer a financial company. Nevertheless, of the forty occasions between 1936 and 1938 where a corporate "insider" sold a sufficiently sizeable stake to mean that disclosure to the SEC was no longer required, in fourteen instances (35 percent) the stake in question was held in a financial company, and in twelve of these cases the issuer was an investment company. Correspondingly, corporate pyramids were uncommon in the sector that experienced the greatest share ownership turmoil in our sample. Moreover, none of the stakes disposed of between 1936 and 1938 were part of the investment-company groups the SEC evidence indicated were part of full-blown pyramidal structures.

In sum, the ownership structure of industrial firms, railroads, and financial companies prior to the mid-1930s likely does more to account for the subsequent rarity of corporate pyramids in the U.S. than does New Deal tax reform. Corporate pyramids appear to have been 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, in most sectors of the economy there was not a large number to begin with.

[70] Pub. L. No. 768; "The Investment Company Act of 1940," *Yale Law Journal* 50 (1941): 440, 444, 455; Securities and Exchange Commission, *Report on the Study of Investment Trusts and Investment Companies, Part Two: Statistical Survey of Investment Trusts and Investment Companies* (hereafter *Report Part Two*) (Washington, D.C., 1939), 365.

[71] See Securities and Exchange Commission, *Report Part Two*, 414–15.

[72] Ibid., Table 123. New York Stock Exchange officials, when they issued guidance in 1931 cautioning against pyramiding in the investment trust sector, were targeting this sort of three-tiered structure: "Cross-Holding of Trust Shares," *Wall Street Journal*, 8 May 1931, 9.

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The Special Case of Utilities

While corporate pyramids were the exception to the rule in the U.S. at the time intercorporate taxation of dividends was introduced, utilities were different.[73] Among the seven of the thirty companies listed by the Twentieth Century Fund in its 1937 study of the effect of taxation on holding-company structures, there were no railways, no industrial companies, one investment company (Atlas), and six utility companies. Moreover, of the fifty-two utility companies in Berle and Means's sample of the two hundred largest non-financial companies, fourteen (26.9 percent) had pyramidal ownership features, a considerably higher proportion than for industrial companies and railways.[74]

Bonbright and Means reported that, as of 1931, 72 percent of national electric power output was generated and distributed by subsidiaries of pure holding companies, organized around nine major systems, and that 42 percent of national gas sales were rendered by subsidiaries of pure holding companies, organized around sixteen holding company systems.[75] Bonbright and Means do not specify whether these holding-company systems were actually pyramidal, but many likely were. As a 1940 study of U.S. business observed, "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."[76]

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 twentieth century, electrical and gas utilities were typically small, isolated, locally owned, locally controlled, and financially weak.[77] The companies frequently 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 high.[78] One response was for engineering and manufacturing groups specializing in supplying utilities with equipment and related

[73] Morck acknowledges the point, writing "the largest U.S. pyramids were built around utility companies." "How to Eliminate Pyramidal Business Groups," 148.

[74] Compiled from Berle and Means, *The Modern Corporation*, Table XIII.

[75] Bonbright and Means, *The Holding Company*, 91, 95. Bonbright and Means said ten groups dominated electric power output, but indicated that one (Consolidated Gas of New York) was not oriented around a holding company (p. 114).

[76] Tippetts and Livermore, *Business Organization and Control*, 2nd ed., 184. See also "Holding Firm Abuse"; EBASCO Services, Inc., *Electric Utility Financing* (New York, 1948), 22–23.

[77] Bonbright and Means, *The Holding Company*, 91, 101–2; Norman S. Buchanan, "The Origin and Development of the Public Utility Holding Company," *Journal of Political Economy* 44 (1936): 31, 32–33, 43.

[78] William J. Hausman and John L. Neufeld, "The Market for Capital and the Origins of State Regulation of Electrical Utilities in the United States," *Journal of Economic History* 62 (2002): 1050, 1053.

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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.[79] The Electric Bond and Share Company, formed in 1905 by General Electric interests, was initially established along these lines.

A second response was for dynamic, ambitious utility executives to use a holding company to gain control of weaker enterprises, with benefits accruing in the form of dividends and management fees paid by the companies acquired. Samuel Insull's utilities empire was built in this fashion.[80] 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, Drexel, and Bonbright.[81]

Though the fractionalized, capital-intensive nature of the early twentieth-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 by paying only what was required to acquire a large block of voting shares.[82]

Legal factors also discouraged wholesale consolidation. As late as 1935, only thirty-three states had corporate legislation authorizing full-blown corporate mergers, which meant that in a sizeable minority of states an outright merger of utility companies in a corporate group could only proceed with the backing of a special legislative act or specially-tailored provisions in the corporate charters of the firms involved.[83] Many states also made it either obligatory or practically essential (e.g., by precluding "foreign" corporations from exercising rights of eminent

[79] Bonbright and Means, *The Holding Company*, 98–108; Thomas P. Hughes, *Networks of Power: Electrification in Western Society, 1880–1930* (London, 1983), 395–98.

[80] "The Insull Utility Empire: Its Amazing Rise and Fall," *New York Times*, 9 Oct. 1932, xx3; Robert Sobel, *The Big Board: A History of the New York Stock Market* (New York, 1965), 243–44.

[81] Bonbright and Means, *The Holding Company*, 127–36; Hughes, *Networks*, 400–1.

[82] Bonbright and Means, *The Holding Company*, 31–32.

[83] Steven A. Bank, "Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws," *North Carolina Law Review* 77 (1999): 1307, 1355.

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domain) for public utility companies doing business within their boundaries to incorporate in-state.[84] Such restrictions meant complete fusion of formerly independent public utility companies within larger utility groups was often unrealistic.

Refraining from implementing wholesale consolidation also could offer regulatory advantages for utilities. Specifically, when a utility enterprise that was brought within a larger corporate group retained a distinct corporate identity, its separateness facilitated the side-stepping of regulation by state public service commissions vested with control over rate-setting, accounting issues, and service provision.[85] 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 the companies offering managerial, financial, and engineering services, could ensure that state regulation only occurred at the operating-company level.

By the early 1950s virtually all utility holding companies had undergone substantial simplification or integration. Did the introduction of the taxation of intercorporate dividends play a role? Our data suggest not, as PUHCA companies reduced stakes only rarely.

In the 1936 SEC volume that detailed shareholding by insiders in the 1,736 corporations registered as public issuers at the end of 1935, of the 424 instances where a corporation owned 10 percent or more of an issuer's shares, 80 of these stakes (18.9 percent) were held by companies falling within the scope of PUHCA.[86] In 1936, among these eighty holdings, the size of the stake declined on only nine occasions and in only three instances was the sell-off large enough to mean SEC corporate insider disclosure was no longer required. The equivalent figures for 1937 and 1938, respectively, were seven out of seventy-six (including three sell-offs) and four out of seventy-three (again including three sell-offs). PUHCA companies thus did not respond to the introduction of intercorporate dividend taxation by engaging in any sort of wholesale disposal of their shares in publicly-traded firms.

The enactment of PUHCA, in contrast with the introduction of intercorporate taxation of dividends, did have some immediate impact. For instance, two of the three 1938 PUHCA-company sell-offs revealed

[84] Bonbright and Means, *The Holding Company*, 33; William Z. Ripley, *Main Street and Wall Street* (Boston, 1927), 296–97; John J. Flynn, "Pyramiding of Holding Companies," *Annals of the American Academy of Political and Social Science* 159 (1932): 15, 16.

[85] Bonbright and Means, *The Holding Company*, 36–37.

[86] The number of instances where companies subject to PUHCA held stakes sizeable enough to require disclosure was greater than the number of holdings relating to issuers we classified as utility companies (59). This was largely because there were various instances where a company falling within the scope of PUHCA owned a stake of 10 percent or more in a public issuer that was not a utility.

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by our data occurred when Central States Electric and American Cities Power & Light sold a combined stake of 78 percent in Electric Shareholdings as part of a reorganization of utilities companies associated with the North American Company. The objective was to ensure that none of the companies constituted a "holding company" under PUHCA.[87] In addition, of the six utilities companies identified in the 1937 Twentieth Century Fund taxation study as engaging in corporate consolidation that were part of pyramidal structures, three specifically cited PUHCA as a reason for proceeding.

It should not be surprising that PUHCA was a catalyst for change, given that its primary objective was to "eliminate the evils connected with public utility holding companies which are engaged in interstate commerce."[88] 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.[89] 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.[90]

While the utility sector did not ignore the enactment of PUHCA, the industry initially resisted the legislation so that its full impact was delayed. In the years immediately following PUHCA's enactment, fifty-eight cases challenged the legislation's constitutionality and some two hundred injunctions were issued by courts around the country to block the SEC from enforcing it.[91] In 1938 the U.S. Supreme Court upheld the constitutionality of the provisions in PUHCA requiring registration with the SEC.[92] Various holding companies then made use of provisions of the Act that permitted them to prepare their own plans for compliance but progress remained slow.[93]

As of 1944 the SEC had issued most of the orders necessary to integrate and simplify the utility industry, but only 22 percent of the assets

[87] "American Cities Power and Central States Sell Electric Shareholdings," *Wall Street Journal*, 30 Nov. 1938, 3; "Many Public Utilities Affected by Williams's Divestment Plan," *New York Times*, 13 Nov. 1938, 61.

[88] Energy Information Administration, *Public Utility Holding Company Act of 1935: 1935–1992* (Washington, D.C., 1993), 9 (quoting a 1947 study of the utility industry).

[89] Public Utility Holding Company Act of 1935, §§ 5, 11(b)(1); "Section 11(b) of the Holding Company Act: Fifteen Years in Retrospect," *Yale Law Journal* 59 (1950): 1088, 1095.

[90] Public Utility Holding Company Act of 1935, § 11(b)(2); William H. Anderson, "Public Utility Holding Companies: The Death Sentence and the Future," *Journal of Land and Public Utility Economics* 23 (1947): 244, 247.

[91] Energy Information Administration, *Public Utility Holding Company Act*, 11; Jerry W. Markham, *A Financial History of the United States, Volume II: From J.P. Morgan to the Institutional Investor (1900–1970)* (Armonk, N.Y., 2002), 206.

[92] *Electric Bond & Share Co. v. SEC*, 303 U.S. 419 (1938).

[93] Energy Information Administration, *Public Utility Holding Company Act*, 11.

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involved had actually been divested.[94] The turning point came in 1946 when the Supreme Court confirmed that the SEC had the authority to compel the reorganization and economic integration of public utility holding companies.[95] With utility holding company executives realizing that further delaying tactics would be counterproductive given a pressing need to finance plant and equipment construction, utility reorganizations were virtually complete by the early 1950s, meaning the end of the corporate pyramid in the one economic sector where it truly flourished.[96] 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 taxation.

Conclusion

The conventional wisdom on corporate pyramids offers a moral for those skeptical of the sprawling business empires that pyramidal corporate structures represent—that vigilance on the part of lawmakers can provide a cure to corporate governance ailments. Pyramidal business groups, according to the orthodox view, became an important part of the U.S. corporate landscape during the opening decades of the twentieth 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 involved, targeted pyramidal structures, using as the primary weapon 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.

In all likelihood, matters worked out quite differently. Our empirical research, based on analysis of corporate holdings of stock in the years immediately following the introduction of intercorporate taxation of dividends, indicates that most companies that owned sizeable stakes in other companies stood pat. Moreover, it does not appear that this lack of selling out can be explained on the basis of fluctuations in share prices or the irrelevance of dividends to corporations and their stockholders during the 1930s. Instead, the most likely explanation for sustained corporate blockholding was the relatively small tax hit that the introduction of intercorporate taxation of dividends imposed.

[94] "The Utility Industry," *Wall Street Journal*, 18 Oct. 1944, 7.

[95] *North American Co. v. SEC*, 327 U.S. 686 (1946); Energy Information Administration, *Public Utility Holding Company Act* 11.

[96] Anderson, "Public Utility Holding Companies," 251; Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Boston, 1982), 257–58.

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While our research indicates that the relative rarity of corporate pyramids in the U.S. likely cannot be attributed to intercorporate taxation of dividends, this conclusion still leaves open the question: why are corporate pyramids currently rarer in the U.S. than in other countries? We have indicated that in the case of utilities, the one sector where pyramids were commonplace, regulation, namely the Public Utility Holding Company Act of 1935, was pivotal. Otherwise, the most likely reason corporate pyramids are the exception to the rule in the U.S. is that they were never commonplace. Why, though, were pyramids a rarity in the U.S. when family-controlled pyramids were prevalent in countries such as Japan and Canada during the opening decades of the twentieth century?[97] It is beyond the scope of our paper to explain why this was the case, but we can speculate briefly.

The Clayton Act of 1914 may have helped to deter the establishment of corporate pyramids, since it prohibited a corporation engaged in interstate commerce from acquiring the stock of another corporation if the result might be a substantial lessening of competition.[98] Regulation, however, may not have played the dominant role in dictating the role of pyramidal structures in U.S. corporate governance. Instead, the key may be that, while pyramidal structures can thrive if capital is scarce because prosperous and well-regarded entrepreneurs and family groups are well-positioned to use their "brand name" to back promising ventures successfully, corporate pyramids languish when capital markets are well developed. Indeed, Masulis, Pham, and Zein report, based on their study of arrangements in forty-five countries, that access to capital does more to explain the prevalence of pyramidal structures than do regulatory variables.[99] Their findings accord with the history of utilities in the U.S., since the difficulties locally-based utility companies faced in 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.

[97] Randall K. Morck et al., "The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada," in *A History of Corporate Governance Around the World: Family Business Groups to Professional Managers*, ed. Randall Morck (Chicago, 2005), 65, 97–101; Randall K. Morck and Masao Nakamura, "A Frog in a Well Knows Nothing of the Ocean: A History of Corporate Ownership in Japan," in *History of Corporate Governance*, ed. Morck, 367, 381–97.

[98] 38 Stat. 730 (1914). On this point, see Klaus Gugler, Dennis Mueller, and B. Burcin Yurtoglu, "Insider Ownership Concentration and Investment Performance: An International Comparison," *Journal of Corporate Finance* 14 (2008): 688, 696 (citing, though, §8, which deals with interlocking directorships, rather than §7). There remained, however, substantial scope for complicated corporate structures to emerge involving non-competing companies: Bonbright and Means, *The Holding Company*, 75–76, 78.

[99] Masulis, Pham, and Zein, "Pyramids," 35–40.

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