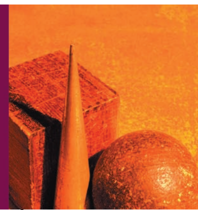

APPENDIX 21A

HOLDING COMPANIES

Holding Company
A corporation that owns sufficient common stock of another firm to achieve working control over it.

Holding companies date from 1889, when New Jersey became the first state to pass a law permitting corporations to be formed for the sole purpose of owning the stocks of other companies. Many of the advantages and disadvantages of holding companies are identical to those of any large-scale organization. Whether a company is organized on a divisional basis or with subsidiaries kept as separate companies does not affect the basic reasons for conducting a large-scale, multiproduct, multiplant operation. However, as we show next, the use of holding companies to control large-scale operations has some distinct advantages and disadvantages.

ADVANTAGES OF HOLDING COMPANIES

1. *Control with fractional ownership.* Through a holding company operation, a firm may buy 5, 10, or 50 percent of the stock of another corporation. Such fractional ownership may be sufficient to give the holding company effective working control over the operations of the company in which it has acquired stock ownership. Working control is often considered to entail more than 25 percent of the common stock, but it can be as low as 10 percent if the stock is widely distributed. One financier says that the attitude of management is more important than the number of shares owned: “If management thinks you can control the company, then you do.” In addition, control on a very slim margin can be held through relationships with large stockholders outside the holding company group.

Operating Company
A subsidiary of a holding company operated as a separate legal entity.

Parent Company
A holding company; a firm that controls another firm by owning a large block of its stock.

2. *Isolation of risks.* Because the various **operating companies** in a holding company system are separate legal entities, the obligations of any one unit are separate from those of the other units. Therefore, catastrophic losses incurred by one unit of the holding company system may not be translatable into claims on the assets of the other units. However, we should note that while this is a customary generalization, it is not always valid. First, the **parent company** may feel obligated to make good on the subsidiary’s debts, even though it is not legally bound to do so, in order to keep its good name and to retain customers. An example of this was American Express’s payment of more than $100 million in connection with a swindle that was the responsibility of one of its subsidiaries. Second, a parent company may feel obligated to supply capital to an affiliate in order to protect its initial investment; General Public Utilities’ continued support of its subsidiaries’ Three Mile Island nuclear plant after the accident at that plant is an example. And, third, when lending to one of the units of a holding company system, an astute loan officer may require a guarantee by the parent holding company. To some degree, therefore, the assets in the various elements of a holding company are not really separate. Still, a catastrophic

loss, as could occur if a drug company's subsidiary distributed a batch of toxic medicine, may be avoided.[1]

Disadvantages of Holding Companies

1. *Partial multiple taxation.* Provided the holding company owns at least 80 percent of a subsidiary's voting stock, the IRS permits the filing of consolidated returns, in which case dividends received by the parent are not taxed. However, if less than 80 percent of the stock is owned, then tax returns cannot be consolidated. Firms that own more than 20 percent but less than 80 percent of another corporation can deduct 80 percent of the dividends received, while firms that own less than 20 percent may deduct only 70 percent of the dividends received. This partial double taxation somewhat offsets the benefits of holding company control with limited ownership, but whether the tax penalty is sufficient to offset other possible advantages is a matter that must be decided in individual situations.
2. *Ease of enforced dissolution.* It is relatively easy to require dissolution by disposal of stock ownership of a holding company operation found guilty of antitrust violations. For instance, in the 1950s Du Pont was required to dispose of its 23 percent stock interest in General Motors Corporation, acquired in the early 1920s. Because there was no fusion between the corporations, there were no difficulties from an operating standpoint in requiring the separation of the two companies. However, if complete amalgamation had taken place, it would have been much more difficult to break up the company after so many years, and the likelihood of forced divestiture would have been reduced.

Holding Companies as a Leveraging Device

The holding company vehicle has been used to obtain huge degrees of financial leverage. In the 1920s, several tiers of holding companies were established in the electric utility, railroad, and other industries. In those days, an operating company at the bottom of the pyramid might have \$100 million of assets, financed by \$50 million of debt and \$50 million of equity. Then, a first-tier holding company might own the stock of the operating firm as its only asset and be financed with \$25 million of debt and \$25 million of equity. A second-tier holding company, which owned the stock of the first-tier company, might be financed with \$12.5 million of debt and \$12.5 million of equity. Such systems were extended to five or six levels. With six holding companies, \$100 million of operating assets could be controlled at the top by only \$0.78 million of equity, and the operating assets would have to provide enough cash income to support \$99.22 million of debt. *Such a holding company system is highly leveraged — its consolidated debt ratio is 99.22 percent, even though each of the individual*

[1] Note, though, that the parent company would still be held accountable for such losses if it were deemed to exercise operating control over the subsidiary. Thus, Union Carbide was held responsible for its subsidiary's Bhopal, India, disaster, and Dow Chemical may be held liable for Dow-Corning's multibillion-dollar silicone breast implant product liability judgment.

components shows only a 50 percent debt/assets ratio. Because of this consolidated leverage, even a small decline in profits at the operating company level could bring the whole system down like a house of cards. This situation existed in the electric utility industry in the 1920s, and the Depression of the 1930s wreaked havoc with the holding companies and led to federal legislation which constrained holding companies in that industry.