PERSONAL

February 8, 1939.

Jerome Frank, Esq.,
Securities and Exchange Commission,
Washington, D. C.

Dear Jerome:

I have on my conscience, and likewise on the debit side of my account, the fact that I have not had a chance to sit down and go over the state of the nation with you. I want to very much, and if you are free and in Washington next week, I am going to have a substantial shot at it. I am also obliged to you for sending me the release; because I am remaking my Case Book in Corporation Finance, and I feloniously intend to use your dissenting opinion as one of the materials therein.

As I construe the Public Utility Holding Company Act of 1935, this is one of the few cases where the Commission really has a chance to lay down some rules in advance governing corporate organization; and the case is therefore a first impression and of first importance. I may say that it would be infinitely easier if that practice could be generally adopted in straight corporate matters, saving all of us a tremendous amount of trouble.

As to the points at issue:

1. I suppose you are entirely right (p. 30) that the Commission is in existence primarily to preserve the capitalist form. The discussion you and I had perhaps a year ago has remained a landmark in my thinking on that score. You are also perfectly right in suggesting that this means providing for contingencies even though they may at the moment appear remote. The position of North American is no more sacred in our economic structure than the position of the Southern Pacific Railroad, though that appeared invulnerable some years ago.

2. You are also dead right in stating that a preferred stockholder whose dividends are in arrears will surrender the arrears to get a minor payment and a resumption of dividends. When I sat on the Stock List Committee of the Exchange, we listed issue after issue of reclassified preferred stock where the reclassification accomplished that and nothing else. We groused about it, but were always met with the fact that the great bulk of the preferred stockholders had agreed to it -- that is, that they had surrendered rather than fought it out. It is true that in many, if not most, cases, the law would probably give them a good fighting chance; at least, this seems to be true since the decision of Keller v. Wilson in Delaware; and some of the more recent New York cases support the view. But it is one thing to have a good lawsuit and another to be able to fight it through.

3. As to the specific provisions suggested you make:

(A) (p. 49) I think your proposal would undoubtedly help: the capital cushion ought to be saved for the preferred.

(B) My belief is that the real safeguard, however, lies in giving the preferred stock control of the board of directors if, as and when preferred dividends remain unpaid or have accumulated to more than a stated amount. This was Hoxsey's conclusion when he was on the Stock List Committee; and I think he was right. Without this, it is almost impossible to prevent either the impairment of your capital cushion, or the working out of a strategic situation in which the preferred stock would cave in. Three years -- or, rather, twelve accumulated quarterly dividends which might be spread out over a much longer period – gives plenty of coercive power to the common stock.

It seems to me that the rough outline of provisions protecting preferred stock ought to be these:

A. No dividends on common stock, except out of current earnings or earned surplus accumulated within one or two previous years.

B. A capital surplus cushion available for dividends on the preferred, but which cannot be otherwise used: i.e., the earned surplus, and the common capital must be exhausted before the capital cushion can be touched.

C. Arrangements for a shift in management whenever this exhaustion takes place, or whenever four accumulated quarters are unpaid.

I haven't checked it in the North American certificate, but there is another thing on my mind. This has to do with the creation of prior preferred stocks or the creation of debt. It is perfectly easy for a management to run up a debt structure whereby the preferred stock, from having been a prior claim on solid assets, becomes the thin edge of a shoestring ahead of which are an indefinite number of obligations. This, of course, is peculiarly true in the holding company situation. In fact, I have about come, myself, to the conclusion that preferred stocks ought not to be allowed in any situation where more than, say, 25%, of the assets of the corporation were held in the form of stocks of other companies,-- that is, where there was a debt or stock incurring machinery which could double the risk factor. The courts do not take this view. More accurately, they allow indefinite creation of debt or prior stock claims ahead of existing stock; and I have yet to see a court which stood up in its boots and limited that power where the risk factor was unreasonably increased thereby.

Let us get together very soon. There is more in heaven and earth just now than is dreamt of in my philosophy; and you, no doubt, will be able to fill in the gaps.

With kind regards, I am, as always,

Faithfully yours,

AAB:ES