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Regulation of Investment Companies

Until the Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies,¹ the first section of which was submitted to the Congress on June 10, 1938, most of the literature on the subject had been either descriptive or promotional.² And it is

¹. Hereinafter referred to as “REPORT”. The Securities and Exchange Commission will hereinafter be referred to as “SEC”.

². See generally: FLynn, INVESTMENT TRUSTS GONE WRONG (1931); Fowler, AMERICAN INVESTMENT TRUSTS (1928); Grayson, INVESTMENT TRUSTS (1931); Harwood and Blair, INVESTMENT TRUSTS AND FUNDS FROM THE INVESTOR’S POINT OF VIEW (3d ed. 1938); Ottinger and Shea, INVESTMENT TRUSTS—A SURVEY OF THE (584)
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singular that although the investment company industry was more than one-third the size of life insurance companies, one-half the size of savings banks, and almost as large as building and loan associations, its development and activities have been practically unattended by federal governmental supervision or effective local statutory restraint. The present indications, however, are that the ring of federal "investor-protection" statutes, begun in 1933 with the Securities Act, and strengthened almost annually thereafter with the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, Chapter X of the Chandler Act, the Maloney Act of 1938, and the Trust Indenture Act of 1939, will be widened, during this or the next session of the Congress, by some form of regulation of investment companies.

The two most obvious examples of institutions dealing primarily with the public's funds which are subject to specific public administrative control are banks and insurance companies. Even those states whose general incorporation laws are the most free have long imposed safeguards around these monied institutions. Banks may not be organized unless an investigation reveals that "the convenience and advantage of the public will be served by the proposed incorporation", that there is a "reasonable promise of adequate support for the enterprise", that "the responsibility, character and general fitness for the business of the incorporators, directors, and officers . . . are such as to command the confidence of the community and to warrant the belief that the business . . . will be honestly and efficiently conducted". Other prevalent statutory provi-

Activities and Forms of Investment Trusts with Recommendation for Statutory Regulation by the State Department of Law, New York (1927); Robinson, Investment Trust Organization and Management (rev. ed. 1929); Speaker, The Investment Trust (1924); Steiner, Investment Trusts American Experience (1929); Williams, Investment Trusts in America (1928); Report of the Committee on Investment Trusts of the National Association of Securities Commissioners (1929); Sen. Rept. No. 1455, 73d Cong., 1st Sess. (1934) 333 et seq.; Shaviro, The Regulation of Investment Companies: What the S. E. C. Will Probably Recommend (1936) 48 Annualist 454; Legis. (1930) 44 Harv. L. Rev. 117; Note (1937) 46 Yale L. J. 1211.


4. Although investment companies were firmly established in Great Britain by the 1870s, the principal obstacle to their growth in the United States was not removed until 1888 when New Jersey became the first state to permit generally a corporation to own the securities of another corporation. By 1921 only 40 such companies had appeared, but in the next six years 139 companies were formed and "by 1929 investment companies were literally being formed at the rate of almost one each business day." Report, Part 3, c. I, p. 3. Of more than 1200 companies known to have been created in the United States only 588 were still active at the end of 1936.

Yearly sales of the security issues of investment companies rose from approximately $400,000,000 in 1927 to more than $3,000,000,000 in 1929. Assets which totalled approximately $700,000,000 in 1926 reached an estimated peak market value of over $8,000,000,000 before the crash in 1929. The decline which followed was as precipitate.

11. Of the 740 investment companies in existence "at some time in the period from 1927 to 1933", 636 were incorporated in Delaware, New York, Maryland and Massachusetts; 377 companies were Delaware corporations. Report, Part 3, c. V, p. 169, n. 9.
sions require a specific capital contribution by incorporators and directors, a fiduciary’s oath by directors, the bonding of those officials who handle funds, frequent examination by and reports to state officials, and the deposit of securities of a certain amount or value with the state. Closely comparable restrictions have been set up for insurance companies. Moreover, those who invest their money in banks, the depositors, are given creditor status generally senior in order of distribution to other creditors, and the federal government has even gone to the length of instituting a system of deposit insurance.

Such regulations and protective measures are now regarded as necessary commonplaces. That banks and insurance companies have apparently prospered under and been strengthened by regulation is a good omen for the investment company industry under the prospective legislation.

The purpose of this note is to discuss the aspects of the subject which will probably be covered by the future investment company act.

I. The Definition of “Investment Company” and Exemptions From the Act

Probably the most difficult as well as one of the most important tasks confronting the draftsmen of the proposed act is the formulation of an effective and flexible definition of “investment company”. The favorable experience of the SEC with the definition of “holding company” under the Holding Company Act should prove a material aid in the solution of this problem.

“Securities companies” is the all-inclusive term covering those organizations whose general activity is dealing in securities, but the investment company should properly fall into a narrower class because it is a particular type of securities corporation. The “more precise formula” utilized by the SEC is stated in its Report as follows:

“A securities company was deemed to be an investment company if more than one-half of its assets, other than cash and United States government securities, consisted of securities other than United States government securities and securities of subsidiary companies which were not investment companies. The term ‘subsidiaries’ was restricted to companies of which more than 50% of the voting shares was owned or controlled by the organization.”


15. The usual textbook definition of an investment company is that it is one whose primary function is to invest its funds in a diversified portfolio of securities without exercising any control or influence over its portfolio corporations. Such a definition is inadequate since it excludes, for instance, any company which does exercise control or influence, the element of control not being always incompatible with an investment company. Moreover, as the SEC points out, the vagueness of the terms used creates the practically insoluble problem of “determining the extent of trading necessary to make a securities company an investment company and the intent with which the securities of portfolio corporations were acquired.” Report, Part I, p. 21.


18. Ibid. “... the determination of the percentage of assets invested in subsidiary companies was on the basis of an unconsolidated statement. However, where the nature of the company was more accurately reflected by a consolidated statement of the parent and its subsidiaries, such consolidated basis was used.” Id. at n. 11.
Even this definition, however, "presumptively" omitted (1) "securities companies with investments primarily in wholly-owned subsidiaries", and (2) "securities companies with investments primarily in non-wholly-owned subsidiaries." 19

It is suggested that for purposes of legislation the SEC's definition should be broadened because the propriety of such omission is questionable. In addition, the broader definition would give greater scope to and more fully effectuate the purposes of the act. As in the Holding Company Act, however, there could be exemption upon application to and order of the SEC, if:

(i) such investment company is intrastate in character, selling or offering for sale its securities solely within the state in which it is organized.

(2) such investment company is only incidentally an investment company, being primarily engaged or interested in one or more businesses other than the business of an investment company. . . .

(3) such investment company is only temporarily an investment company. . . .

(4) such investment company is not, and derives no material part of its income from any subsidiary which is, a company the principal business of which within the United States is that of an investment company. 20

In addition, as in the Securities Act, there could be self-executing exemptions, 21 the more important of which would make clear that the act does not cover banks, building and loan associations, insurance companies, companies subject to the Holding Company Act, personal holding companies, mortgage guaranty companies, school districts, municipalities and other governmental units, and organizations operated exclusively for religious, educational or charitable purposes.

The question then seems to resolve into what percentage of assets invested in portfolio securities—for security holding is "the common denominator" 22 of all securities companies—shall identify a company as an investment company. The answer will probably be reached by a compromise effected by the statutory draftsmen and the spokesmen for the industry.

Using tools furnished by the SEC, the writer ventures a definition which would both delimit the general field of activity, identifying a securities corporation, and yet fix a minimum percentage of assets in securities, thereby creating a "physical condition" test which would single out an "investment company".

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19. Id. at 23. The SEC more fully describes the companies in (1) and (2). The former are companies "whose assets consist exclusively, or almost exclusively, of securities of one or more wholly-owned or substantially wholly-owned corporations. . . . The parent company has absolute control over its portfolio corporations—its subsidiaries—and these subsidiaries do not differ, in essence, from operating divisions or units within a single organization. . . . These parent securities companies, if the legal fiction of distinct corporate entity be disregarded, may in essence be deemed to be engaged in the business of its portfolio corporations." Id. at 18.

The latter are companies "whose assets consist primarily of investments in securities of one or more corporations in each of which the securities company owns 50% or more but less than 100% of the outstanding voting shares, an amount sufficient to insure absolute control under ordinary circumstances." Id. at 10.


“Investment company” means any corporation which is engaged, either directly or through subsidiaries, primarily in the business of owning securities of other corporations, or in the business of investing and re-investing, or trading, for the purpose of revenue and for profit, in securities, purchased with funds raised by the sale publicly of its own securities, more than 10 per cent. of the assets of which, other than cash and United States government securities, (provided said 10 per cent. is $100,000 or over) shall consist of securities, other than United States government securities and securities of affiliates which are not investment companies.

The 10 per cent. figure suggested has several merits: it would serve to prevent evasion of regulation by perversion of portfolio policies; it is sufficiently large ($100,000 or over) to admit of cognizable public investor interest; it will serve to place the burden of obtaining exemption on those companies which claim to be without the purview of the act; and it will broaden the coverage of the act by reaching those companies regulation of which should clearly be the very purpose of the legislation.

II. THE CREATION OF INVESTMENT COMPANIES

A. Sponsors or Promoters

The abuses which appeared from the SEC’s investigation of this phase of the industry have included the promiscuous creation of investment companies where no economic need for them existed; the frequent lack of ability and experience on the part of sponsors or promoters of companies the chief appeal of which lay in the promise of expert security analysis and investment management; conflicts of interest in the sponsors, especially in the predominant groups of investment bankers, brokers, security dealers, and other professional financing groups; self-dealing; failure to make adequate disclosure to investors; complete and arbitrary con-

23. The Continental Chicago Corporation raised a net capital of $63,750,000, although at the time The Chicago Corporation, sponsored by the same investment bankers, was unable to find investment opportunities for its $59,375,000 of capital funds. Report, Part 3, p. 101. The sponsors received a gross underwriting fee of $2,625,000.

24. The statistics of the SEC indicate that generally the performance of closed-end and opened-end investment companies “was virtually identical with the 90 common stock index” which is made up of “unmanaged” securities. Report, Part 2, c. VI. (Note, however, the limitations on these statistics cited in the Report.)

25. This abuse has been recognized as such by prominent members of the industry. See for example the statements of Mr. Louis G. Kaufman and Col. Samuel McRoberts in connection with Chatham Phenix Allied Corporation, Report, Part 3, c. II, pp. 113-114; Mr. Philip R. Clarke and Mr. Henry M. Dawes in connection with the Petroleum Corporation of America, id. at 266-267, 337; Mr. Gerald Beal in connection with Continental Securities Corporation, id. at 422-423. These are only a few of the many such statements made in the course of the investigation. See also the statement by the SEC, Report, Part I, p. 74.

26. "While the losses in a number of investment companies were attributable principally to the security market decline and general business decline, in many cases the substantial losses sustained by investment companies were the result of the numerous transactions which the sponsors, managers, officers, directors and other controlling interests effected for their own account with the investment companies which they dominated." Report, Part 3, c. I, pp. 27-28.

27. Thus, for example, "nothing in the charter of Petroleum Corporation of America or in the public announcements which accompanied the issuance and distribution of its stock even remotely indicated that the corporation was intended as a vehicle for advancing the plans of Sinclair and his banking associates to consolidate various oil
trol over the financial and capital structure; 28 failure by the sponsors to make capital contributions commensurate with the position and interests they obtained in the enterprise; 29 failure by the sponsors to assume and live up to their fiduciary duties; 30 and excessive compensation. 31

The initial problem becomes one of co-ordination of the spheres of state and federal activities in regulating the creation of these companies. In the absence of a federal incorporation act, the possibility of which has been held remote, 32 "there seems to be no reason . . . why Congress cannot require all corporations desiring to engage in interstate commerce to subject themselves to some degree of federal regulation by obtaining a federal license." 33 Therefore a specific investment company licensing provision could be spelled out in language comparable to that in Section 5 of the Securities Act: 34

Unless a certificate of approval has been obtained from the Securities and Exchange Commission, it shall be unlawful for any investment company to utilize the facilities of interstate commerce.

This certificate of approval, or federal license, should be issued in the case of new investment companies only upon the satisfactory conclusion of an extensive investigation into the economic demand for and prospects of the company; affiliations of the sponsors; the capital contributions made by them; their interests in any property being acquired by the company; and the compensation, its amount and form, being received by them. Even the personal records and experience of the sponsors may well be investigated, just as in the radio broadcasting field. 36 The sponsors should be required further to make an affidavit that the company was being formed in good faith and in compliance with all the rules and regulations which the SEC should have power to prescribe. Adequate disclosure of material facts to investors may also well be prescribed.

Explicit, of course, in such statutory regulation should be the essential requirement that conflicting interests be segregated. This would neces-

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29. Dillon, Read & Co., for example, the sponsor of United States & Foreign Securities Corporation, invested $5,100,000 in that company in comparison with the public's contribution of $25,000,000. The public had a first lien on the company's assets to that extent, and a right to 25% of the voting power and surplus profits. The sponsor which had contributed 16.9% of the capital received, inter alia, 75% of the voting power and a right to 75% of the surplus profits. REPORT, Part 3, c. V, p. 35. Within approximately four years, the block of common stock held by the sponsor had an unrealized appreciation of 10,000%. Ibid.

30. See VI, Shifts in Control, infra p. 607.

31. Although the security holders had lost within four years time approximately 59% of the capital they had contributed to the Federated Capital Corporation, the sponsor and his controlled companies had "received in salaries, selling commissions, and management fees a total of $86,337.73." REPORT, Part 3, c. IV, p. 307. See also the discussion of the Continental Chicago Corporation, note 23 supra, and of Mr. Wallace Groves, REPORT, Part 3, c. II, p. 231.


sitate the declaration that no investment banker, broker, or dealer could act as sponsor of an investment company. And to prevent pyramiding, one investment company should be prevented from sponsoring another.36

Some doubt has been expressed37 as to the powers of Congress to regulate the corporate structure and internal affairs of state corporations licensed to engage in interstate commerce, but respectable authority has long since banished such doubt.38 The SEC's Report strongly demonstrates the pressing public necessity for supervision and control.39 It should need little further buttressing to clinch the view that, in the investment company field, "Congress should have the power to protect the national commerce by any means appropriate to the purpose."40

B. Directors

The abuses in relation to directors have included the use of important names as "fronts" and "window-dressing";41 failure to disclose those actually in control of the company;42 failure by directors to make adequate capital contributions;43 conflicts of interests and self-dealing;44 the use of charter and by-law clauses sanctioning conflicts of interest and enabling ratification of all acts of the directors in the absence of fraud;45

37. Berlack, note 32 supra, at 409 et seq. The "reconstruction" of the Supreme Court may have changed this attitude.
39. Such legislation "would be based upon the theory that a corporate organization is but a means of transacting commerce, and that under its power to regulate interstate and international commerce Congress can prohibit the transaction of such commerce by means of any corporate organization which in its opinion is unsafe or otherwise prejudicial to the interstate commerce of the public." Id. at 682.
41. Mr. Walter P. Chrysler was a director of the United States & Foreign Securities Corporation, although he attended only one meeting out of the 28 held during his two years on the board. Report, Part 3, c. III, p. 117. Several titled Englishmen and other prominent men were directors of Federated Capital Corporation although they rarely, if ever, attended meetings. Id. at 118. Mr. Charles F. Kettering was apparently elected to the board of Yosemite Holding Corporation without his knowledge or consent. Id. at 110. The American Capital group of investment companies "pursued the consistent policy of securing men of local or national prominence to comprise the several management groups." Id. at 120. See especially the "advisory board" and the "economic council" of the Investment Company of America. Id. at 121 et seq.
42. See note 27 supra.
44. The history of almost any of the investment companies will illustrate such abuses, but see especially Central-Illinois Securities Corporation which suffered losses of approximately 49% of its original $15,000,000 capital and whose difficulties arose largely from the conflicts of interest with its sponsors. Report, Part 3, c. II, p. 121 et seq. The Petroleum Corporation of America, which within six years suffered a loss of over $54,000,000 largely through ventures undertaken at "the dictation of its dominant influences", was the source of "tangible cash benefits in excess of $18,000,000" for this same dominant group. Report, Part 3, c. II, p. 233 et seq.
45. The certificate of incorporation of Central-Illinois Securities Corporation contained the following provision:
"In case the corporation enters into contracts or transacts business with one or more of its directors, or with any firm of which one or more of its directors are members, or with any other corporation or association of which one or more of its directors are stockholders, directors or officers, such contract or transaction shall not be invalidated or in any way affected by the fact that such director or directors have or may have interests therein which are or might be adverse to the interests of this corporation; provided that such contract or transaction is entered into in
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a stagger system of electing directors to perpetuate control; 48 seriatim resignations as a device to shift control; 47 and lack of minority representation on the board. 48

Such abuses naturally bring up the entire problem of "directors who do not direct" 49 but certain prophylactic measures would seem to be peculiarly applicable to investment companies. The legislation should seek to give the security holder "as a matter of law" 50 something "more than the loose expectation that a group of men under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation." 51 This can be accomplished by imposing express statutory fiduciary duty on all directors to the security holders as well as to the entity. 52 Directors should also be required to take an oath honestly and diligently to perform their duties without violating the act or permitting it to be violated. 53 Together with the signed affidavit to such effect should be a verification that the director meets all the statutory or administrative standards imposed on investment company directors.

As in the case of sponsors, investment bankers, brokers, or dealers should be prohibited from being directors of investment companies because of the practically inevitable conflicts of interest that arise. 44

There should be set up in addition a minimum requirement for capital contribution by directors, based preferably on some administrative yardstick perhaps dependent on the amount of authorized, offered or sold securities. Shift in ownership of securities should cause disqualification as should failure to attend meetings for a specified period of time, such as

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46. By this means directors are divided into groups or classes, only one of which is elected at each annual meeting. Consequently more than one annual meeting may be necessary in order to bring about a change in the majority of the board. The by-laws of Oils & Industries, Inc., and of Tri-Continental Corporation contained such provisions. The boards of both companies could also fill vacancies provided by the increase in their membership. Report, Part 3, c. V, p. 370.

47. This practice arose out of the power of the boards of directors to fill vacancies occurring between annual meetings. Thus an old director would resign and a new one be elected and this process continued until a new board was created. Since this happened between annual meetings, the shareholders were ignorant of this change in their board. This device was extensively used by, among others, Mr. Wallace Groves in acquiring four investment companies, Report, Part 3, c. II, § 6; by the Northern Fiscal Group in the acquisition of three companies, id. at § 9; and by the Fiscal Management Group in the acquisition of three companies, ibid.

48. One of the very few instances of minority representation was found in Insur- anshares Corporation of Delaware. When the minority directors protested about some practices, however, "all transactions . . . were approved by the investment committee of the company" whose meetings were so arranged that the minority member "never quite got" to them until they were over. Report, Part 3, c. IV, p. 227, n. 733.


54. Harwood and Blair, op. cit. supra note 2, at 39, take the contrary view on the ground of practicability. Any one interested or primarily engaged in the sale of securities may not at the same time serve as an officer, director or employee of a national bank. 49 Stat. 709 (1935), 12 U. S. C. A. § 78 (1936).
Moreover, *seriatim* resignations by directors, which have resulted in secret shifts of control, and the stagger system of electing directors, which has perpetuated control, should be outlawed, while the power of the board to fill interim vacancies should be restricted, perhaps as in the New York Banking Law, to one-third of its number. Similarly, the directors should be denied the power to fill positions resulting from an increase in their number.

To protect the minority security holders and to narrow the gap between "ownership" and "control", a provision for minority representation on the board may well be considered and perhaps included. Mandatory cumulative voting has already proved helpful in bringing this about. And needless to say, full disclosure must be required to be made to security holders of the affiliations and backgrounds of incumbent directors and those to be elected.

Other general problems for legislative consideration are the bonding of those officials handling the funds or negotiable securities of the company; prohibitions against the use of the "over-all" sanctioning clauses referred to above, and against dealings between the company and the directors in their individual capacities. Similarly, any profit made by the directors from the use of their inside information should be recoverable by the corporation. This realistically should mean a prohibition of emoluments and patronage and the forbidding of the acceptance by directors of any fees, commissions or gifts from others for their obtaining from the investment company loans, investments, underwriting business, or the like. To compensate for the abolition of what might hitherto have been considered legitimate fields for directors' activities, consideration should be given to the suggestion that yearly salaries be fixed instead of the customary nominal attendance fee.

At least some restrictions on the powers of directors over the portfolio are in order. Such statutory limitations should, in effect, make all investment companies semi-fixed in character, and, in furtherance of the true corporate purpose of investment companies, prevent directors from pledging portfolio securities to buy control of other companies or from otherwise failing to maintain the type of diversified portfolio on the strength of which the public invested its funds.

Another protective measure is embodied in the suggestion that the internal accountants of the company be raised to the rank and dignity of director with its resultant duties and responsibilities.  

56. N. Y. Banking Law, § 119.  
57. See Douglas, note 49 supra, at 1330.  
59. General Empire Corporation liquidated a large portion of its portfolio to secure funds to lend to its parent, Atlas Corporation, to acquire control of Chatham Phenix Allied Corporation. Report, Part 3, c. IV, p. 156. In a little more than a year's time Insuranshares Corporation of Delaware liquidated practically its entire portfolio realizing a loss of almost $12,000,000 based on the cost of those securities. The $4,596,000 cash proceeds were used to further the plans of its dominant group in gaining control of other companies. Id. at 222. See also the discussion of the "purchase of control with the acquired company's funds", id. at 379.  
C. The Corporate Purpose

The essential idea behind an investment company proper is that it is a device whereby many investors can pool their funds to obtain equally the benefits of diversification of risk and expert management. In practice, however, this was not always true. In many cases the failure to maintain a diversified portfolio developed out of the conflicts of interests and self-dealing on the part of sponsors and directors resulting in the company's portfolio being loaded with the securities of affiliated or "system" companies. In some instances the company was used to sponsor other investment companies or as a device to gain control over a phase of industry or finance, thus subordinating the investment expectation, of the security holders to the desires of the insiders. In few cases was adequate disclosure made to the public investors prior to these shifts in investment policy or corporate purpose.

The conflicts of interests also manifested themselves in other malpractices. The creation of investment companies was frequently induced by the desire to obtain profits from the underwriting and security business incident thereto. Since the sponsors were more interested in this profit, they consequently paid less attention both to the management of the portfolio and the interests of the security holders. Moreover, when the collapse of the market occurred, the investment company was not infrequently used to bail out its sponsors, as a dumping ground for poor investments, or as a device to bolster a falling market, with resultant detriment to its own security holders.

To prevent the recurrence of such abuses, the legislation should require a clear statement of the corporate purpose. If that purpose is to be investment in a diversified portfolio, within the definition suggested above, then the words "investment company" should be included in the corporate name. All other corporations should be enjoined from using names giving the impression they are investment companies. The literature of the company should contain a statement that a company is organized under and in accordance with the act. Perhaps the act should confer power on the SEC to regulate by rule or order the types and amounts of particular securities that may be held, and even the percentage of industry diversification allowable. At least annual, and possibly more frequent reports to investors should be required disclosing the percentage of the company's holdings in the various securities, and whether and to what extent the portfolio securities are in affiliated or "system" com-

61. The most amazing example of this practice is the experience of Eastern Utilities Investing Corporation under the domination and control of Mr. H. C. Hopson and the Associated Gas and Electric Company. Report, Part 3, c. II, p. 727 et seq.
63. See note 27 supra.
64. On the contrary, in the case of Eastern Utilities Investing Corporation repre-sentations were made as to the diversification of its portfolio at a time when over 90% of its investments were in the securities of the Associated Gas & Electric system. Report, Part 3, c. II, p. 796. See also VI, Shifts in Control, infra p. 607.
66. Id. at 28.
panies. Necessary, of course, would be a physical check of the portfolio by an independent accountant. 67

The restrictions discussed in the section on Directors to be placed upon their powers over the portfolio will help to maintain the diversity of investment. The other suggested provisions seeking to abolish the conflicts of interest in sponsors and directors will also prevent the use of the investment company for personal ends. Furthermore the legislation should contain an affirmative provision requiring a high percentage of security holders' approval of a charter amendment to change the corporate purpose. Such amendment, like any other amendment to the certificate of incorporation, should be fully publicized and, in addition, subject to the prior approval of the SEC.

In addition to the previously mentioned prohibition against the pledge of assets, a restriction that loans to a particular corporation or individual shall not exceed a stated percentage of the unimpaired capital of the company would also tend to preserve the basic function of the company and maintain the necessary liquidity of assets. Moreover, some limitation, both as to amount and period of holding, should be put upon the company's dealings in its own securities since extensive operations of this kind may pervert the corporate purpose and, as will be seen, 68 react in other ways to the detriment of the security holders.

Finally, whenever an investment company offers its securities on the market, whether its original or a subsequent issue, full disclosure should be made of the specific purpose and the amounts to be devoted thereto for which the security offered is to supply the fund, just as in the Securities Act. 69

D. The Capital Structure

The capital structure 70 of investment companies was largely the result of defects in the industry, but in turn it spawned still other abuses. To begin with, the sponsors had complete control over the original capital set-up 71—frequently with disastrous results. By utilizing the multiple-security structure involving more than one outstanding class of securities, sponsors were enabled to obtain immediate and prospective control of a large pool of public funds for a relatively small capital contribution. 72 And, by taking equity securities rather than senior securities, the sponsors were in a position to receive the major portion of the profits of the company. 73 If the company subsequently suffered reverses forcing the senior

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67. "The accountant's failure to check physically the possession of the portfolio securities of the investment companies enabled the sponsor to conceal its conversion of these securities." Report, Part 3, c. II, p. 57, on Seaboard Utilities Shares Corporation, Railroad Shares Corporation and Utilities Hydro & Rail Shares Corporation.
68. See IV, The Repurchase of Securities, infra p. 602.
70. "... the capital structure discloses the type or types of claims and the nature of the participating interests which the company has conferred upon the holders of its various securities." Report, Part 3, c. V, p. 2.
71. "The 'capital' or 'capitalization' of an investment trust or investment company is the fund raised by the trust or company to devote to the purpose for which the trust or company has been formed." Ibid.
72. Ibid. p. 30.
73. Ibid. Since both bonds and preference stocks have rights to earnings and assets of the company superior to the common stock, the term 'senior securities' is employed to distinguish both of these classes from the common stock. Common stocks, on the other hand, which have deferred claims to income and the assets of the company, are frequently termed 'junior securities'. Common stocks are frequently termed 'equity securities' in contradistinction to the 'senior' securities which have no share in the residual earnings or assets of the company." Report, Part 3, c. V, p. 13.
securities "under water" and leaving the equity securities with no asset value, the sponsors were still able to benefit themselves. Because their block of common stock carried the control with it, the sponsors could sell it at a great premium thereby retrieving their own investment but leaving the remaining security holders, who never heard about the transaction till after its consummation, in the hands of a new controlling group which usually had designs of its own. 74

Since the contribution received by the company for its equity securities acts as a protective cushion for the senior securities, the amount of that contribution is important. In theory, the senior security holder gives up his right to an unlimited participation in the profits in return for this protection. And yet as a result of the small contribution made by the sponsors for the equity securities the protective cushion was totally inadequate, very often from the inception of the company. 75 Furthermore, as a direct outgrowth of the small capital contribution made by the sponsors, coupled with the disproportionately large share of the profits accruing to them as holders of the common stock, the company was often caused to engage in highly speculative policies. 76 Resort was also had to these policies in an effort to meet the high fixed charges of the senior securities. 77 Besides all this, the highly complex capital structure put the general investor at a further disadvantage since it became increasingly difficult to analyze and evaluate the securities. 78

The senior securities giving rise to the leverage 79 which proved so profitable for the insiders were usually themselves inadequately protected. The preferred shareholders suffered from a "thin" capital cushion 80 and from a lack of voting rights. 81 Actually their "preferences" were often illusory, vanishing at the very moment when they were needed. Thus various maneuvers were gone through depriving the preferred of their priority rights on liquidation or dissolution. 82 And because the vote of the com-

74. See VI, Shifts in Control, infra p. 607.
77. See the testimony of Mr. Jonathan Lovelace, one of the sponsors of the Investment Company of America, REPORT, Part 3, c. V, p. 117; testimony of Mr. Edwin Rankin of the United Founders Corporation group, id. at 118.
78. This was especially true of Eastern Utilities Investing Corporation which had outstanding "one series of debentures, three series of preferred stock, one series of participating preferred stock and two series of common stock . . . and each type of security had different rights, privileges, qualifications and limitations". REPORT, Part 3, c. V, p. 129. The financial structure of the Central States Electric Corporation and its affiliated companies, under the domination of Mr. Harrison Williams, was even more complex. See the testimony of Mr. Williams, id. at 155, and of Mr. Clifford Stone, president of Shenandoah Corporation and Blue Ridge Corporation, id. at 157.
79. "Leverage" is a term applied to investment companies having "outstanding senior securities with fixed or relatively fixed maximum participations in the corporate assets and earnings. . . . As a consequence, any given change in the total assets will give rise to a more than proportionate change in the equity of the common stock." REPORT, Part 1, p. 33.
80. See note 75 supra.
81. In almost all investment companies the voting power resided in the common stock which was controlled by the sponsor or other inside group. In some cases, however, the default in the payment of preferred dividends for a stipulated period created a voting right in the preferred. Even this contingent right was circumvented in the case of the American Capital Corporation which had an affiliated company, Pacific Southern Investors, Inc., controlled by the same sponsors, buy up enough of the defaulted preferred to keep the existing management in power. REPORT, Part 3, c. V, p. 267.
82. See the testimony of Mr. Carroll E. Gray, Jr., in connection with the history of Burco, Inc., the control of which was sold to a new management group. The new
mon stock was necessary to liquidate the investment company, this possibility was frequently ignored where it would have been the most prudent step in order to protect the preferred. Moreover, common dividends were in some instances paid out of capital or capital gains. The power in the directors to allocate contributions received for securities facilitated this practice. The common stock-control was also exercised to coerce the preferred shareholders into yielding their rights to accumulated unpaid dividends. The senior position of the preferred was at times similarly impaired by the creation of additional bank indebtedness or of another class of preferred with additional rights. The repurchasing of securities also adversely affected the preferred.

Even where funded debt—bonds and debentures—formed part of the capital set-up, the holders of these securities were in fact in a precarious position. Thus:

“The debenture holders were the recipients of practically none of the safeguards or protections which frequently accompany bonds or debentures. The debentures were not supplied with a cushion of assets; they had no ‘touch-off’ clause; no sinking fund requirements; no reserve for interest; no provisions precluding the payment of dividends on common stock before interest on the debentures was fully paid or when the debentures were not fully covered by assets; no prohibition against the issuance of additional debentures having a priority over or a parity with existing debentures except in certain instances; no provision automatically accelerating the maturity of the debentures in the event of default in the payment of interest; and

83. "As early as April 9, 1930, the lack of success of Ungerleider Financial Corporation led to requests by stockholders of the company that it be dissolved. Samuel Ungerleider & Company, however, refused to assent to a dissolution of the company, first, because it would have reflected upon the prestige and reputation of the firm, and, second, because it was felt that the downward trend in the market for securities might cease in the near future." REPORT, Part 3, c. IV, p. 251. See also the history of Atlantic Securities Corporation where "the alternative of dissolution of their corporation was not offered to the preferred shareholders". Id. at 278.

84. See the discussion of the practices of United States & International Securities Corporation, American Capital Corporation, and Jackson & Curtis Securities Corporation. REPORT, Part 3, c. V, p. 172 et seq. Similarly, the United Founders group of investment companies "failed to segregate profits from the sale of investments from the other earnings" although Dr. L. R. Robinson, who was active in the management of those companies, had urged the adoption of such practice in his book on investment companies. Id. at 182; ROBINSON, op. cit. supra note 2, at 361-368.

85. Those states in which the majority of investment companies have been incorporated permit the allocation of contributed capital to paid-in surplus and the payment of dividends therefrom. DEL. REV. CODE (1935) c. 65, §§14, 34; 1 MD. ANN. CODE (Bagby, 1924) art. 23, §39; 2 MASS. GEN. LAWS (1932) c. 150, §§15, 35; N. Y. STOCK CORP. LAW §§12, 13, 58.


87. Thus The Equity Corporation "hypothecated its entire portfolio, including the stock to be purchased with the proceeds of the loans, to secure loans from a bank in order to acquire Reliance International Corporation, another investment company". REPORT, Part 3, c. V, p. 421. Mr. David Milton, president of The Equity Corporation, testified concerning this transaction with the bank: "We told them that we would give them anything that they would like to have." Id. at 243.

88. See the discussion of Kiidder Peabody Acceptance Corporation. REPORT, Part 3, c. V, p. 251 et seq.

89. See IV, The Repurchase of Securities, infra p. 602.
no provisions specifying events of default or remedies upon defaults." 90

The existence of a "touch-off" clause 91 providing a minimum percentage of coverage for the funded debt is generally considered "a vital safeguard", 92 but even where it was provided its effectiveness depended on the kind of provisions "made in the indenture for the immediate and accurate detection of the relationship of net assets to the amount of bonded indebtedness, the nature of the rights which the bondholders acquire if the 'touch-off' point is reached, and the provisions for the expeditious enforcement of these rights". 93 The indenture provisions were not infrequently rendered ineffective in this respect by their vagueness. 94 Furthermore, the "touch-off" clause was not an unmitigated blessing since, to avert its enforcement, the management was sometimes moved to liquidate the portfolio. 95 The mere presence of a "touch-off" clause often aroused a conflict of interest between the funded debt holders who wished its protection and the shareholders who wished to avoid its enforcement.

Beyond these problems peculiar to themselves, funded debt holders, like preferred shareholders, suffered from the payment of dividends out of capital, repurchasing activities, the creation of additional securities or bank indebtedness, the lack of voting rights and generally reckless management policies. 96 All the evidence points to a legislative requirement that investment companies issue only one uniform class of securities 97 a common stock having a par value and general, equal voting rights. 98

Of importance is the fact that the creation of senior securities is, in reality, "a gamble on net capital gains" 99 since it has been shown that the rate of net current earnings of investment companies over a period of years has been less than the rate of the fixed charges on the senior securities. In other words, the cost of issuing funded debt has averaged over 5 per cent. and the cost of issuing preferred stock has averaged over 6 per cent., while the average net earnings on total assets has been about

91. A touch-off clause is a "covenant that the company will, at all times maintain a certain minimum coverage for the bonds or a margin of assets over total liabilities". REPORT, Part 3, c. V, p. 9. If the assets fall below the prescribed percentage that is a default with the possibility of foreclosure and receivership.
92. REPORT, Part 3, c. V, p. 295. See also GRAHAM AND DODD, SECURITY ANALYSIS (1934) 211-212.
93. REPORT, Part 3, c. V, p. 295. See also GRAHAM AND DODD, op. cit. supra note 92, at 201-203.
94. "It may be said generally that the majority of investment companies which did include a "touch-off" provision in the indenture rendered the 'touch-off' clause ineffectual by failing to introduce sufficiently definite criteria with respect to the elements of the covenant and by failing to impose upon the trustee any responsibility in connection with the ascertainment of compliance or any standard of accountability to bondholders for abstaining from enforcing a default." REPORT, Part 3, c. V, p. 295.
95. The Trust Indenture Act of 1939, 53 STAT. 1149 (1939), 15 U. S. C. A. § 77aaa (Supp. 1939), is an attempt to remedy many of these problems.
96. REPORT, Part 3, c. V, p. 324 et seq.
98. See BERLE AND MEANS, op. cit. supra note 50, at 249 et seq.; DOUGLAS, note 49 supra, at 1330.
3½ per cent. A superior management performance has not material-
ized to make up for this lack of margin between net current yield and net
cost of senior securities. And the possibility of capital gains is itself such a fluctuating and uncertain one that the issuance of senior securities
would appear economically unjustifiable.

To this must be added the host of abuses described above, made possible by the presence of a multiple-security structure. As stated by the SEC:

"The senior security holders are interested in only such a margin
of operating profit as will suffice to pay them the limited fixed annual
return; the equity security holders are interested in a broad margin
of profit, as all of the earnings except the fixed charges will inure
to them. The senior security holders have been sold their securities
on the theory of the safety of their principal, while the equity security
holders have been sold their securities upon the theory of 'leverage',
greater play for their money, or speculative advantages. Yet the con-
trol of the fund, and consequently the safety of the senior security
holders' investment, is almost invariably completely in the hands of
the equity stockholders, to whom the fulfillment of the pledge of
safety is wholly entrusted.

"In the very fact that senior and equity securities have different
rights, privileges and protections, lies the seed of conflict of inter-
est." 

This conflict of interest is, of course, antipathetic to the essential purpose
of investment companies as a mutuality of undertaking. Moreover, the complex capital structure prevents the senior and equity security holders
from ratably sharing in both the diversification of risk and the success
of the company. The senior security holders cannot share equally in the
profits of the company since their participation is limited; the junior
security holders cannot share equally in the diversification of risk since
their contribution is subject to the first hazards of the company.

The inescapable conclusion thus seems to be that the most wholesome
capital structure for an investment company calls for only one uniform
class of security. A common stock having a par value and general, equal
voting rights would narrow the gap between "control" and "ownership" would assure all the shareholders an equal participation in the company
in accordance with its true economic functions, would abolish largely the
conflicts of interest inherent in the multiple-security structure, and would
prevent many of the abuses which the security holders have previously
experienced.

As a further protection, the rule adopted by the SEC as to public
utility holding companies and their subsidiaries should be extended to
investment companies, namely, that except upon application to, and ap-
proval by order of the SEC, no such company shall declare or pay any
dividend out of capital or unearned surplus. In general, the payment
of dividends should be permitted only out of that income received by the
investment company as dividends or interest on the portfolio securities.
Closely related to the capital structure of the investment company is the problem of control. By use of the multiple-security structure, as already pointed out, the sponsors and other insiders were able to obtain and perpetuate their control. This was also accomplished by means of the form of business association adopted. Thus the trustees of the "Massachusetts Trust" type of investment company 107 and the managers of the joint stock company type of investment company 108 were comparatively free from all control by investors. The SEC has stated that "the organic form of some investment companies was in no small measure dictated by a desire to control large pools of funds without the necessity for any substantial investment by the managers." 109

The advocated common stock type of security with full voting rights, when coupled with the regulation of the proxy machinery 110 and control of the issuance of option warrants, 111 would obviate many of the difficulties arising from this situation. Thereby, a closer connection between "control" and "ownership" should result, entailing a greater voice in the management of the enterprise for the public investor. The suggested provisions requiring capital contributions by sponsors and directors would also work toward this end. In addition, however, a time limitation should be set on the running of voting trust agreements 112 and management contracts. 113 And, in accordance with provisions established by many states

107. At the end of 1936, 20 management investment companies proper were of the "Massachusetts Trust" type of organization. Report, Part 2, vol. I, c. 2, Appendix Table 16.
108. The Adams Express Company is the only investment company which is a joint stock association. Report, Part 3, c. V, p. 383.
110. For a newspaper discussion of the reaction to the proposed new proxy rules of the SEC, see N. Y. Times, Dec. 31, 1939, § 3, p. 1, col. 1. See also Dean, Non-Compliance With Proxy Regulations (1939) 24 CORN. L. Q. 483; Note, Regulation of Proxy Solicitation by the Securities and Exchange Commission (1939) 33 ILL. L. REV. 914.
111. Specific information concerning the issuance of option warrants must be given in the schedule filed under the Securities Act of 1933, 48 STAT. 88 (1933), 15 U. S. C. A. § 77aa (Supp. 1939).
112. Apparently because of the lack of sales appeal of a company utilizing the voting trust, the device was infrequently adopted, only 9 out of 150 companies examined by the SEC having such an agreement. Report, Part 3, c. V, p. 407, n. 208.
113. In those states having statutes legalizing the voting trust, a 10 years limitation is usually placed upon it. Because of the "autocratic" powers vested in the trustees under these agreements, it may seriously be doubted whether their use should be permitted at all in investment companies. New York prohibits the voting trust in banking corporations. N. Y. STOCK CORP. LAW § 50.

The existence of a management contract subjects the company to the possibility of the same abuses of powers as in the case of the voting trust agreement, Report, Part 3, c. V, p. 416. As of Dec. 31, 1935, 68 investment companies had management contracts. Id. at 419. Thus although those sponsoring and directing investment companies sold their securities on the basis of representations as to their management abilities, they in effect delegated their powers in this respect to others. See as to this Sherman & Ellis v. Indiana Mutual Casualty Co., 41 F. (2d) 588 (C. C. A. 7th, 1930), where the court held unenforceable as against public policy a 20-year management contract granted by the directors to a management company.

The entire subject of management contracts, investment counsel and the like is worthy of an extended discussion which space will not allow to be made here. See, however, the supplemental report made by the SEC in connection with its over-all study of investment trusts and investment companies, Report on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services.
for banks and insurance companies, the legislation on investment companies should stipulate that only the corporate form of organization be utilized.\textsuperscript{114}

\textbf{III. The Sale of Securities}

Many abuses arose in connection with the sale of securities by investment companies.\textsuperscript{115} Again there was the conflict of interest in sponsors and directors as a result of their activities in professional financing groups.\textsuperscript{116} This led to the dictation of underwriting agreements without benefit of competitive bidding.\textsuperscript{117} Another result was the failure of underwriters, in the great majority of cases, to make firm commitments. Instead they promised merely to use their "best efforts".\textsuperscript{118} Even where firm com-


\textsuperscript{115} 'It is ... estimated that the grand total of sales of securities by investment companies of all types from their inception in this country up to the end of 1937 was approximately $7,200,000,000.' Report, Part 2, vol. 2, c. 3, p. 5. Of this amount $5,500,000,000 worth of securities were sold during the period 1929-1936. Ibid.

\textsuperscript{116} An additional development within the investment company industry has been the installment investment plan by which "substantially, a certificate or security was sold to the public on the installment plan which represented an interest in some underlying security—a security of a fixed trust or of a management investment company (either closed-end or open-end) or a diversified group of portfolio securities". It was claimed that these various plans were developed to fill an economic need—an outlet whereby persons in the lower income brackets could invest in common stocks. There seems, however, to have been little actual evidence of such an "economic need", and basically the installment investment plan appears merely to have been another device for selling securities—more high-pressured, frequently more deceptive and more costly.

The device, moreover, was permeated with all sorts of abusive practices. There were an incredible number of secret and excessive fees charged to the investor with resultant profit to the sponsors, who were frequently inexperienced. The sponsors notably failed in their fiduciary duties and the so-called "trustees" also failed to live up to their position. Although called "trustees" and widely advertised as such, they were little more than custodians of the underlying securities. The sales material was high-pressured and deceptive, and various "sweetening" measures, especially insurance and loan provisions, were adopted to aid in the sale. Within a period of seven years, the certificate holders of 33 plans, representing almost this entire phase of the industry, had lost approximately 33% of their investment. See generally the SEC's Supplementary Report on Companies Sponsoring Installment Investment Plans; Installment Investment Plans—How Not to Save $10 a Month (1940) 1 Your Investments 38.

The installment investment plan has been shot through with so many abuses and has proved itself of such doubtful worth that it might be argued that the device should be entirely abolished. If not, however, the provisions suggested in this note would bring about much-needed reforms. Above all, a regulation of the fees distributing them uniformly over the entire life of the plan, the prohibition of deceptive literature and high-pressured selling schemes, the imposition of active fiduciary duties on sponsors and custodians and full disclosure to investors would be necessary.\textsuperscript{116} Report, Part 3, c. III, pp. 93, 156.

\textsuperscript{117} Id. at 93.

\textsuperscript{118} Id. at 98. "One consequence of the widespread use of the so-called 'best-efforts' underwriting contracts was that the closed-end investment companies and their prospective shareholders had no assurance that the amount of capital which the prospectuses anticipated would ever be raised." Ibid.
mitments were actually made, underwriters, who were also the sponsors, were sometimes released from their obligations when the market fell.\textsuperscript{119} “Sponsors-underwriters” also in other ways liquidated their original investment in the company, usually without any disclosure to the other security holders. Despite this they often retained control.\textsuperscript{120}

Even without their assumption of responsibility, underwriters often received varied and excessive compensation from the company, not all of which was disclosed to the security holders.\textsuperscript{121} Underwriters sometimes exacted excessive and secret fees from investors so that the company actually received a lesser portion of the capital contributed by the security holders than was represented.\textsuperscript{122} The SEC reports that all sorts of high-pressure and manipulative selling practices were resorted to in the actual sale of investment company securities to the public.\textsuperscript{123} These naturally caused an artificial market evaluation of the securities, which only served to place the company in a false position and delude investors. Sometimes as soon as the investment company was established, extensive switching operations were attempted.\textsuperscript{124}

Of course, since the passage of the Securities Act, the Securities Exchange Act, and the Public Utility Holding Company Act, many of these conditions have been remedied. The underwriting contract is now attached as an exhibit to the registration statement filed with the SEC. The contract must also be summarized in the statement and in the prospectus. Thus disclosure is made of all commissions or discounts received by the underwriters, directly or indirectly, of all options received by them and of all preferential rights granted them as to future issues of the registrant. Furthermore, Sections 11 and 12 of the Securities Act, imposing civil liability for any untrue statement of a material fact, or failure to state a material fact in the registration statement or prospectus, cover underwriters.

But although these matters are thereby disclosed, no definite prescribed form or content for the underwriting agreement has been laid down. What has been said in another connection seems aptly to point the

\textsuperscript{119} Examples are found in Ungerleider Financial Corporation, \textit{id.} at 168, and Federated Capital Corporation, \textit{id.} at 171.

\textsuperscript{120} Examples are found in United States & Foreign Securities Corporation, \textit{id.} at 174, American, British & Continental Corporation, \textit{id.} at 178; and General American Investors, Inc., \textit{id.} at 183.

\textsuperscript{121} 184 management investment companies reported to the SEC that they had paid $116,510,000 to market $2,109,000,000 worth of securities. Thus the compensation to the underwriters averaged about 5.5\% of the selling price and 5.8\% of the net proceeds to the company. \textit{Id.} at 156. This merely represents the cash compensation. Remuneration also took the form of option warrants, free stock and the indirect benefits resulting from the control and management of large pools of funds.

\textsuperscript{122} See the discussion of the practices of T. I. S. Management Corporation, sponsor and depositor of Trusteed Industry Shares, \textit{id.} at 60 \textit{et seq}. The investment trust received only 88\% of the funds contributed although the prospectus stated that the trust would receive approximately 91\1/2\%. \textit{Id.} at 69.

\textsuperscript{123} Connections with important individuals and corporations were sought and then widely exploited; security issues were “sweetened” by means of conversion privileges, free stock and option warrants; unit offerings and part-paid security issues were also used; and various market operations were carried out. \textit{Id.} at 113 \textit{et seq}.

\textsuperscript{124} “The nature of open-end companies and fixed trusts, particularly their obligation to redeem their shares or certificates at asset value, has made their securities vulnerable to ‘switching’ operations, i.e., attempts by dealers to persuade customers to sell the shares of one investment company and to use the proceeds to buy those of another. Distributors, dealers and salesmen profited from each sale of an investment company issue, whether the sale involved the investment of additional funds by a customer or merely his liquidation of one issue to buy another. Such operations may, however, be costly to investors since they may involve the payment of a new load on each shift.” \textit{Refozr, Part} 2, \textit{vol.} 2, \textit{c.} 3, pp. 40-41.
way to proper handling of this phase of the subject under the prospective investment company act:

"Specific statement in a statute, within minimal and practicable limits, has several advantages. It makes more definite and certain the business and legal rules involved. Furthermore, the isolation and specific treatment of the various malpractices and abuses which have arisen will make for more effective administration and control." 125

Despite the opposition which will undoubtedly be strongly voiced, the statutory requirements of competitive bidding and firm commitments by underwriters for investment company securities should be productive of the best results for the industry.126 In addition, it would be advisable that a prescribed schedule of fees and a standardized method of calculating the basis selling price of the security be authorized to be set out by the SEC. The information called for under the Securities Act 127 in connection with the registration statement merely includes data as to the method by which such selling price is computed; the investment company act should go further and, for purposes of uniformity and certainty, enable the SEC to standardize this method.

Existing legislation has already made unlawful the puffing or depressing of security prices through the use of manipulative devices in sales and trading.128 The Securities Exchange Act,129 so effectively administered by the SEC, will continue to prove a salutary check on such activities, as far as listed investment company securities are concerned. However, the check on the use of manipulative devices on sales and trading of over-the-counter investment company securities will, in large measure, depend on the effectiveness of the self-regulating associations under the Maloney Act.130 Legislative consideration need, therefore, be given merely to such additional powers necessary to be conferred on the SEC so that unlawful over-the-counter market operations in investment company securities may be systematically and efficiently prevented.

IV. THE REPURCHASE OF SECURITIES

Coincident with the investment companies efforts to sell its securities were its frequently extensive market operations in repurchasing its own securities.131 Thus the sponsors sometimes forced the company to "maintain" the market during distribution despite the fact that the underwriting commissions being paid were adequate to cover such operations by the underwriter.132 These repurchases also aided the sponsors in their secondary market operations after the completion of the original distribu-

126. The requirement of competitive bidding has been bitterly opposed in the hearings before the Temporary National Economic Committee. See N. Y. Times, Jan. 9, 1940, p. 31, col. 8; Jan. 11, 1940, p. 31, col. 1. See also Lockwood and Anderson, Underwriting Contracts, Within Purview of Securities Act of 1933; With Certain Suggested Provisions (1939) 8 Geo. Wash. L. Rev. 33.
131. "During the years 1927 to 1936, investment trusts and investment companies repurchased or redeemed approximately $1,200,000,000 of their own securities, valued on the basis of the cost to the trusts and companies." Report, Part 2, vol. 2, c. 3, p. 9. Cf. note 115 supra.
The usual reason given for these subsequent repurchases was that they were "to police" the market or were "to bring the price in line with other issues." Naturally these operations were carried on secretly, and whether they were for the stated purpose or really to prepare the market for additional financing or to facilitate exchange offers, the result was that the security holders could not accurately appraise the securities, and thereby the market ceased to fulfill its function.

After 1929 repurchases increased considerably. In the beginning they were generally made to support or stabilize the precipitately declining market. But at least part of these operations were induced by the sponsors' desires to protect their own prestige. At the same time, however, these operations incidentally enabled the sponsors to use company funds to enhance the value of their own holdings and provided them with brokerage commissions.

Following the collapse in the market, the market value of investment company securities in practically all cases fell below their actual asset values. It followed, therefore, that if the company repurchased its own shares it would profit by the difference between the two values, and this was the chief reason advanced for the large scale repurchases that were effected. While it is true that the company and the remaining security holders profited thereby, it is nevertheless true that those who disposed of their securities suffered to the same extent. The treatment of the latter became increasingly inequitable because they had no knowledge of the extent of the discount at which they were selling their shares nor any information that the investment company, rather than the general public, was buying their shares. Furthermore, these extensive repurchasing operations, together with the secrecy usually surrounding them, had the effect of bolstering the prestige of the management and increasing unreasonably the security holders' confidence. Although generally repurchases were justified as being the "best buys" at the time, there was no such disclosure to the selling security holders. This, the SEC indicates, perhaps violated the existing fiduciary relationship. In any event, the repurchase of securities reduced to that extent the working capital of the company and enabled the management to shift at will the asset value underlying the securities.

133. Ibid.
134. REPORT, Part 2, vol. 2, c. 3, p. 57. It should be noted, however, that the prices of these other issues may also have reflected "stabilizing" or market operations. Ibid.
135. BERLE AND MEANS, op. cit. supra note 50, at 174-176; Berle, Liability for Stock Market Manipulation (1931) 31 Col. L. Rev. 264. From January 30 till September 1931 Tri-Continental Corporation engaged in extensive repurchasing operations, representing approximately 85% of all reported transactions in that security on the New York exchanges. REPORT, Part 3, c. III, p. 205. The price of the stock was kept above 90 although comparable securities were rapidly declining. Id. at 207, Chart I. The market price broke to 58½ when the company decreased its repurchases. Id. at 208.
136. Thus "approximately one-third of total repurchases [of closed-end companies] were effected in the year 1930, alone". Id. at 189. See also REPORT, Part 2, vol. 2, c. 3, Table 19.
137. Berle, note 135 supra, at 278, n. 25.
139. Id. at 193.
140. The average discount was approximately 35%. See the testimony of Mr. Floyd Odum, REPORT, Part 3, c. IV, p. 1, n. 1; for the SEC's statistics see REPORT, Part 2, vol. 2, c. 4.
141. Id. at pp. 58-61.
142. REPORT, Part 3, c. III, p. 204.
143. Ibid.
144. Id. at 205.
145. Although there is a fairly general statutory provision that repurchases be made only out of "surplus", the adaptable definitions of "capital" and "surplus" may nullify
Where the repurchases were of common stock while preferred stock was outstanding, the effect was to reduce the capital cushion available to the preferred. Where the repurchases were of funded debt securities or preferred stock, the effect was to create a profit on behalf of the common—which was usually held by the sponsors. But a still more dangerous purpose of the repurchase of bonds was to prevent the operation of “touch-off” clauses. By repurchasing bonds and debentures below their principal amounts, the company’s debt was reduced proportionately more than its assets, thereby increasing the percentage of asset coverage of the remaining outstanding bonds above the level provided in the “touch-off” clause. By such action, however, the management, which in many cases was itself largely responsible for the financial plight of the company, was enabled to continue in office at a time when it might have been more advantageous to the security holders to liquidate the enterprise.

Repurchases were at times made from insiders who were thus enabled to sell their securities at a higher price than they could command in the market because of the size of their holdings. The insiders thereby profited without any disclosure being made to the other security holders. Where these repurchases were at premiums over the asset value dilution of the assets of the remaining security holders naturally resulted. Repurchases were also made to eliminate opposition elements to the management and as a device to facilitate mergers. In neither case was there disclosure to the security holders.

These operations in general became so widespread that on May 26, 1930 the Listing Committee of the New York Stock Exchange passed a rule forbidding investment companies from purchasing their own shares of stock save in exceptional circumstances. "The theory apparently was that to put the trading corporation in the market adversely to its own shareholders was too unsound a situation to be encouraged." The repurchase of securities by holding companies or their subsidiaries has since been closely regulated by the Public Utility Holding Company Act. It is suggested that similar regulations be applied to investment companies. Application for the approval of the acquisition of securities should be made to the SEC setting forth, inter alia, a balance sheet of the company, a description of the proposed transaction and its effect on the operations and financial condition of the company, its effect on the security holders, the identity of the sellers of the securities to be acquired.

For the general thesis that repurchasing operations accomplish a re-capitalization of the corporation without conforming to statutory provisions, see Levy, Purchase by a Corporation of its Own Stock (1930) 15 Minn. L. Rev. 1. At least 20 different offers of exchange were sent to the debenture holders of Eastern Utilities Investing Corporation from 1931 to 1935. When the trustee notified the company of a default, efforts were made to secure enough debentures to amend the indenture by abrogating the “touch-off” clause, which was subsequently accomplished. Id. at 259.

Liberty Share Corporation paid on an average of double the asset value in repurchasing its own shares. Id. at 237.

See the discussion of Oils & Industries, Inc., id. at 242; National Investors Corporation group, id. at 243.

Perhaps the best known example is the market operations of The Goldman Sachs Trading Corporation which was combined with Financial and Industrial Securities Corporation. Within four days the stock of the Trading Corporation rose from $136.50 per share to $222.50 per share, twice its asset value. Id. at 257.


and their relationship to the company, with information as to what safeguards are being adopted to assure fairness. The fees or commissions to be paid should be disclosed and a statement made of the requisite action taken to conform to provisions in the certificate of incorporation, state laws or federal regulations. The amount of such repurchases permitted in any calendar year should be limited to a percentage of the total assets of the investment company.

The malpractices attendant upon the repurchase of securities were greatly exaggerated by the existence of a multiple-security structure since the management was then enabled to shift asset values and to favor its own holdings. The suggested simple capital structure would, however, eliminate the possibility of such abuse.

The SEC should have the power to disclose any information necessary to protect the security holders. Nevertheless, confidential essential business secrets should be protected since there are instances in which market operations by the company are in fact defensive or protective measures. But as Professor Berle has written:

"The answer to this question lies precisely in the matter of disclosure. If the investor is aware that the market price represents operations of the corporation itself, he at least has in his possession information permitting him to evaluate the apparent appraisal of the market price. He may then act, at his peril, to be sure, but at least with knowledge of what the apparent market quotation really means. The vice of the present situation is that he is permitted and induced to act on the strength of a supposed situation which in fact does not exist."

V. THE MANAGEMENT AND OPERATION OF THE COMPANY

The SEC's Report discloses case after case in which those in control of the company failed to conduct its business primarily for the benefit of the security holders. As has been constantly reiterated, the conflicts of interest were such that self-dealing became rife. In fact, the investment company was often merely used to further the purposes of the sponsors. Thus the company became a device to extend control, to sponsor other companies, to support other financial ventures, to buy the securities of affiliated or "system" companies and to make loans to insiders. All of these functions are, of course, quite apart from the purchase for investment of a diversified portfolio of securities, a function which the general investor took to be the purpose of an investment company. In this way the discretionary power of the management over the portfolio was abused, and, as pointed out above, these changes in investment policy and corporate purpose were in many cases made before notifying or securing the consent of the security holders.

Another not unusual practice was for the sponsors to pyramid investment companies and systems of companies to get the advantage of the consequent leverage and, incidentally, of the underwriting business. Sometimes the management attempted to impart an air of propriety to these varied activities by including in the certificate of incorporation a contractual waiver of the general prohibition against self-dealing or by securing a subsequent blanket ratification of all acts of the management. Reports to the security holders were both infrequent and inadequate, and the accounting practices adopted helped give an inaccurate picture of the condition of the company. The various fees and other forms of compen-

154. Berle, note 135 supra at 278.
vation received by the management were sometimes excessive, and the sponsors further profited by the sale to the investment company of securities in which they were interested. Moreover, the very liquid character of the assets of an investment company made it easy for an unscrupulous or dishonest person to divert them to his own use.

The general investigation of the character, ability and responsibility of those sponsoring and managing investment companies; the imposition of affirmative fiduciary duties; the bonding of those handling funds or negotiable securities; the prohibition against dealings between the company and its officials in their individual capacities; the prohibition against contractual waivers and "over-all" sanctioning clauses; the segregation of conflicts of interests; the provision enabling the corporation to recover from the directors any profits made by the use of inside information; the standardizing of accounting practices; the regulation of the solicitation of proxies; the requirement of a physical check on the assets by an independent accountant; the simple capital structure; the requirement of more frequent and fuller reports to shareholders; the limitation on charter amendments affecting the corporate purpose; and the constant requirement of disclosure to the SEC—all will tend to check and prevent these management abuses.

Where management contracts are entered into, a time limitation should be placed upon them. The compensation paid under such contracts should be a flat fixed amount, rather than a fee contingent upon profits or securities bought and sold or assets controlled, since the latter form of compensation enables the managers to be paid irrespective of the operative experience of the company. 155

Of considerable moment is the desirability of the imposition of some limitation upon the scope of the management's discretion over investment policy. To be taken possibly as a working basis for such limitation, in accordance with the suggestions made in relation to the corporate purposes, are the covenants actually adopted by some companies providing:

"that the corporation make no investment: (a) in real estate; (b) which involved promotion or management on the part of the corporation of other enterprises; (c) in any corporate stock or other security which represented participation in the business risk of any new and unproved enterprise; (d) in any security about which reliable information was not available with respect to history, management, earnings and income, of the governmental authority, corporation or organization issuing the same." 156

To realize true diversification, there was also "a categorical prohibition against the investment of more than 5 per cent. of the assets of the company in the securities of any one corporation or other organization." 157

A clear definition of "assets" and of the accounting practices by which they are to be determined would, however, be necessary to effectuate fully the covenant. 158 The covenant should, furthermore, be strictly construed.


156. See note 113 supra. Cf. ROBINSON, op. cit. supra note 2, at 401.

157. This provision was in the indenture of Pacific Southern Investors, Inc. REPORT, Part 3, c. V, p. 350.

158. Ibid.

159. Id. at 351-355. For typical investment restrictions see ROBINSON, op. cit. supra note 2, Appendix D.
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VI. Shifts in Control

Another aspect of the operation of investment companies, but one to be treated separately, concerns those problems and abuses arising out of the shifts in control of such companies with subsequent merger or consolidation or dissolution. Because the market values of investment company securities were on an average 35 per cent. below the asset values, following the crash of 1929, a profit equal to the difference between the two values could be made by acquiring the securities of a company at the market price. Companies were formed for the very purpose of taking advantage of this situation and an active market developed in the barter and sale of investment companies. The acquiring corporation did not have to pay cash but could issue its own securities as consideration and could then subsequently realize the true asset value of the acquired securities through dissolution, merger or consolidation. The high degree of liquidity of the assets of investment companies and the virtual absence of any regulation of their activities also offered an opportunity for those acquiring the companies to divert the assets to their own use. Moreover, profit could easily be realized by acquiring several such companies and selling one to another.

Although those in control owed a fiduciary duty to the security holders who had, in most instances, already suffered large losses under the existing management, little or no attempt was made to protect the

160. See note supra.
161. Examples are The Equity Corporation and Yosemite Holding Corporation, REPORT, Part 3, c. IV, p. 4, n. 6.
162. Apparently in some instances shifts in control were made to cut operating and management costs. See testimony of Mr. Earle Bailie in connection with Tri-Continental Corporation. Id. at 6, n. 8.
163. Thus certain individuals, referred to by the SEC as the Fiscal Management Group, acquired control of four investment companies "without the expenditure of any of their own funds. In essence, their scheme was to contract to buy a controlling block of stock of an investment company; to pay for this block of stock with funds borrowed on the portfolio securities of the very investment company to be acquired; to take control of the investment company and immediately liquidate the portfolio securities in order to raise the cash needed to pay off the loan; to transfer the controlling block of stock to the Fiscal Management Company, Ltd., their personal holding company; to reimburse the investment company for its portfolio securities sold by transferring to the investment companies preferred stock of the Fiscal Management Company, Ltd., and other securities of doubtful value; and to take in connection with these transactions substantial commissions and profits. Having once acquired control of an investment company, the group used the funds of this company to acquire control of other investment companies." Id. at 72.
164. This was the technique of Mr. Wallace Groves, who "within a year and a half . . . had acquired control of five investment companies at a nominal cost to himself, and had sold out his control holdings of the top company of the holding company system for approximately $1,000,000". REPORT, Part 3, c. II, p. 176.
165. That a fiduciary duty existed was conceded by many sponsors and managers. REPORT, Part 3, c. IV, p. 8, n. 13.
public investors in these transactions. Apparently the insiders were too much swayed by the opportunity to sell their common stock which had no asset value, but which brought a considerable premium since it controlled the corporate assets which belonged to the senior security holders. No investigation was made of the ability, integrity or purpose of the acquiring group; no attempt was made to maintain the investment policy of the company; no effort was made to secure a similar offer to purchase for the general investors; and "almost invariably" the sale of control was never disclosed to the security holders till after the transaction had taken place. The result was that:

"... following the undisclosed shift in control of their companies minority shareholders often found themselves interested in companies which no longer invested in diversified securities, but which were associated with the acquiring corporation in obtaining control of other investment companies. Investment companies which formerly were not operated under management contracts now were administered under management contracts by the terms of which the controlling corporation received an annual compensation based on a percentage of the assets of the managed company. A stockholder, dissatisfied with the change in policy, had no alternative but to sell his stock in the market at prices less than their actual value in assets. And the acquiring corporation, in the then condition of securities markets, was usually the only market bidder for his shares. As such sole bidder the acquiring corporation usually fixed a market price less than the liquidating value of the security but greater than the existing market prices of comparable securities. That the market value of their shares was higher than the market values of comparable securities may have been an inducement to stockholders of acquired companies to sell their shares."  

An essential part of the procedure in acquiring investment companies was the extensive use of exchange offers of the securities of the acquiring corporation for the securities of the acquired corporation. The purchasing group had control of the common as a result of their dealings with the insiders. But the common stock had no asset value, all equity of the acquired company belonging to the senior securities. To recoup the premiums paid for the common and to obtain the asset values behind the preferred, the purchasing group would put into motion an intensive campaign of exchange offers. All independent sources of advice for the security holders were in effect cut off because the acquiring company offered commissions and other compensation to all brokers, dealers, bankers, and the original sponsors, for their recommendation or active solicitation of exchanges. Sometimes information which was inaccurate or misleading...
was disseminated and, to lend added appeal to the offer, the market price of the securities was "stabilized." The terms of the exchange offer were within the sole control of the acquiring company. In many cases, the acquiring company held the number of securities required by state law for the approval of one of these methods. In any event, by its superior position the purchasing group could push through any plan it fixed upon. Dissenting minority shareholders were left virtually helpless.

The proposed legislation should enact into law the principle that "the control of an investment company is akin to a power in trust for the benefit of the company's stockholders." Certainly under no circumstances should directors or managers be permitted to sell the controlling block of stock or a management contract without first completely disclosing to and securing the consent of the security holders. A full investigation should have to be made of those intending to acquire the company, and specific safeguards set up to assure maintenance of the investment policy of the company and that its assets are not dissipated.

Under the usual provisions of general incorporation statutes, where shifts in control are contemplated, directors of the two companies decide which, if any, of the available statutory procedures is to be adopted—dissolution, merger, consolidation, sale of assets or recapitalization by charter amendment. Having then worked out the details of the plan to be followed, they submit it to the security holders for approval. Dissenters, if they have taken the requisite steps, may, in certain instances, get the appraisal value of their shares. But the situation contemplated by these statutes did not exist where a single controlling group was on both sides of the plan so that arm's length dealing was impossible, where those creating the plan had conflicting interests with the security holders and where all independent, unbiased judgment was eliminated.

Investment companies should be regulated in this respect in the same fashion as are banks and insurance companies. The main provision of this aspect of the legislation should be that the plan put forward would be subject to the approval of the SEC as well as of the security holders.

171. Thus the management performance of the acquiring corporation was exaggerated by salesmen who also represented that the exchange offers had been approved by the courts. Id. at 410-411.

172. See the discussion of the operations of the Atlas Corporation. Id. at 415, 420 et seq.

173. Id. at 427.

174. Ibid.

175. Id. at 393-395.

176. Id. at 472.

177. The SEC, even where it has the power to require disclosure under the Securities Act of 1933 of matters effecting exchange offers, has no complementary power to judge the fairness of such offers. Similarly most Blue Sky Laws do not empower local securities commissions to pass on the fairness of exchange offers. Moreover, the more strict Blue Sky Laws can be avoided by having the exchange offer technically take place in one of the "liberal" states. All the exchange offers of Atlas Corporation took place in New Jersey. Id. at 397, n. 11.


179. Every person holding directly or indirectly more than 10% of any equity security must make a statement of his holdings to the SEC, and a monthly report of any change. 48 Stat. 896 (1934), 15 U. S. C. A. § 78 (p) (Supp. 1939).

180. The merger or consolidation of any bank must usually be approved by the superintendent of banking and two-thirds or three-fourths of the shareholders. See, for
The SEC should act on these plans in the same way it now acts on a reorganization plan of a public utility holding company under Chapter X of the Chandler Act and Section 11 (f) of the Holding Company Act. The ultimate end would be "the fair plan" arrived at by negotiation, with the important added factor that the approval of a disinterested, unbiased expert would be available and, in fact, necessary. Full disclosure of all the aspects of the proposal would thus be made to the security holders.

VII. Bankruptcy and Reorganization

The last important problem concerns the bankruptcy and reorganization of investment companies. As to this aspect, the SEC should be given the same statutory powers to examine the affairs of the investment company that the federal government has given the Comptroller of Currency in relation to federal reserve banks and that the states have given their superintendents of banking and insurance commissioners in relation to those other financial institutions. Reports at periodic intervals during the year should be made to the SEC, which should also be given the power to examine under oath officers and directors of the company. In the event of an impairment in the financial condition of the company, which is not remedied within a stipulated period of time, the SEC should be able to step in and take over the operation of the company in the same way that the superintendent of banking takes over an insolvent bank.

If it proved impossible to restore the company to a sound basis, then application to the court could be made under Chapter X of the Chandler Act for the appointment of a disinterested trustee. Under Section 208 the SEC may, with the approval of the judge, and must, if the judge requests, become a party to a proceeding for all purposes except to appeal and receive compensation. Under Section 172 of Chapter X, the reorganization plan must be referred to the SEC "for examination and report" where the debtor's indebtedness exceeds $3,000,000. If the indebtedness is less than that amount the judge may, nevertheless, refer the plan to the SEC. In the latter case, it has been the practice of the SEC to make application for participation "where the face amount of the debtor's publicly held securities" is more than a quarter of a million dollars.

Thus under the already existing set-up, the SEC has an important advisory and regulatory role. Given the added powers suggested to

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188. Ibid.

189. Panuch, note 182 supra, at 102.

190. This procedure has apparently worked with conspicuous success in the reorganization of Reynolds Investing Company, Panuch, note 182 supra, at 104.
cope with the situation confronting the company before it goes into bankruptcy and reorganization, the SEC will be enabled on an even more extensive scale to protect the public investors.

CONCLUSION

The manifold abuses pervading the investment company industry that have been uncovered, especially by the SEC's Report, are apt to cause a somewhat prejudiced view towards the institution itself. The point to be remembered, however, is that the investment company has never had a fair opportunity to achieve its purposes. Almost invariably it has been distorted by other interests. If kept to its appointed task by regulation such as that here suggested, the writer feels that the investment company would justify its great economic and social possibilities as a vehicle for offering an outlet to capital and a channel to supply capital to industry, diversification of risk to the investor coupled with the further advantages of constant security analysis and expert independent management. All too often these true "purposes were aspirations rather than practices." The legislation should make them realities, and the essence of the proposals suggested is to place the investment company in its rightful position as a financial institution.

E. P. R.

Related Problems in the Assumption of a Mortgage Debt

Throughout American jurisdictions there is great difference of opinion in the situations discussed below, as to a mortgagee's right to enforce a deficiency judgment against the mortgagor or his grantee who assumed the mortgage. Any attempt to rationalize all American cases on these points would seem to be impossible, and this is largely due to the fact that the law is at present in the process of development. In view of this fact, then, it may be important to attempt to discern in what direction the trend is moving and what solution to these problems the law should ultimately provide.

THE BASIS OF LIABILITY

At common law a mortgagee could not enforce a deficiency judgment against a purchaser of the mortgaged property who assumed the mortgage, since he, as mortgagee, was not a party to the contract of assumption. Such is still the law of England. In the United States, however, he now has such a right in some circumstances, but the basis thereof is not everywhere the same. He was first allowed to recover from the assuming grantee, if he could do so at all, under the theory of "equitable (quasi) subrogation", a rule which was the product of two opposing forces. Courts had begun to recognize the need for allowing certain types of "third party beneficiaries" to sue on a contract made for their benefit, and yet there was a natural hesitancy to ignore so "fundamental" a concept as the requirement of

2. Massachusetts may be classed as the single exception. There he can do so, if at all, only with the grantor's consent. Coffin v. Adams, 131 Mass. 133 (1831).
"privity". Hence arose this compromise rule, which, be it noted, would have been equally applicable to any other "creditor beneficiary" contract.

Under this rule, the mortgagee brought his suit against the mortgagor, who, in relation to the assuming purchaser of the mortgaged property, was as a surety to his principal debtor. Then, under the equitable rule that a creditor is entitled to all the securities of the principal debtor which are in the hands of the surety, the mortgagee succeeded to the assuming grantee's promise to pay the debt. And since all the parties are then before the court, the assuming grantee's promise will be then and there enforced to avoid circuity of action.

Various other jurisdictions have adopted a more simple rationale. The mortgagee is allowed to sue the assuming grantee simply as a third party beneficiary, i.e. one for whose benefit the promise to pay the debt was requested. But here again the rule is subject to variations from state to state, ranging, for example, from Connecticut where it is sufficient that the promisee-grantor intend to confer a cause of action upon the mortgagee, to Kansas where the mortgagee may recover under this rule only where the promise was requested for his "sole and exclusive" benefit.

Thus it will be seen that the rules of recovery here are made to depend on the more general rules of contract—the rights of third parties for whose benefit the contract was made. Those rules are still in a period of growth, not only from state to state, but even within a given jurisdiction. As they change, the corresponding mortgage law likewise changes, but more slowly, and this is one of the great sources of confusion. New Jersey, for example, still retains the subrogation theory in its mortgage law though third party beneficiary recovery is permitted by statute. New York, still employing the subrogation theory, also allows recovery under the beneficiary theory, where the mortgagee may be regarded as a creditor.

Each one of the steps in the growth of the beneficiary rule is marked in mortgage law. Minnesota at one time found that this situation gave rise to a trust, Rhode Island once held that the mortgagee could recover under a theory of novation, both of which devices were once common in contract law to permit recovery where the rule of "third party beneficiaries" had not yet been established.

It is of course difficult to discuss the relative merits of these two theories, "subrogation" and "beneficiary", apart from their application to

3. "In short, if one person agrees with another to be primarily liable for a debt due from that other to a third person, so that as between the parties to the agreement the first is the principal and the second the surety, the creditor of such surety is entitled, in equity, to be substituted in his place for the purpose of compelling such principal to pay the debt." Keller v. Ashford, 133 U. S. 610, 623 (1890).
5. Schneider v. Ferrigno, 110 Conn. 86, 147 Atl. 303 (1929).
7. Such is the case even in New York. 2 WILLISTON, CONTRACTS (Rev. ed. 1936) § 368. Seaver v. Ransom, 224 N. Y. 233, 120 N. E. 639 (1918); (1918) 27 YALE L. J. 563; (1919) 17 MICH. L. REV. 342. 8. See note 9 infra.
9. N. J. REV. STAT. (1937) 2: 26-36, passed in 1903 and allowing a beneficiary to sue in any court. Yet in Feitlinger and Federal Trust Co. v. Heller, 112 N. J. Eq. 209, 164 Atl. 5 (1933) a mortgagee was denied equitable relief, the decision being based on the relationship of the parties in the eyes of equity.
11. Follansbee v. Johnson, 28 Minn. 311, 9 N. W. 882 (1881).
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specific cases, yet there is this much to be said: there appears to be no good reason why the contract whereby a grantee assumes a mortgage should be treated differently from any other contract made for the benefit of a third person, notwithstanding historical precedent to the contrary, and since the right of a "third party beneficiary" to sue has become so well established in American contract law, the need for such a cumbersome and comparatively unrealistic theory as that of "equitable subrogation" should hardly be considered pressing.

THE EFFECT OF THE GRANTOR’S NON-LIABILITY

It is at once apparent that where one who purchased the mortgaged property without assuming the mortgage conveys to one who covenants to assume it, the latter's liability to the mortgagee can be made to depend on the theoretical basis of mortgagee's rights discussed above. If the jurisdiction in which the problem arises is committed to the subrogation doctrine, the mortgagee cannot recover, since the original mortgagor has no claim upon his own non-assuming grantee and hence none against the last and assuming grantee. There is no promise from the first grantee to which the mortgagee can be "subrogated". As is commonly said, the chain of liability has been broken. On the other hand, if recovery by a third party beneficiary is permitted generally, the mortgagee may or may not be able to recover, depending upon what particular variation of that doctrine is in vogue. Where, as in Kansas, West Virginia or Missouri only a "sole and exclusive" donee beneficiary is allowed to sue, the mortgagee's action will almost always fail. On the other hand, where a donee is regarded merely as one upon whom the promisee intended to confer a right of action, he would recover. A like distinction exists with respect to a creditor beneficiary's right to sue. Ordinarily, under this concept, the mortgagee could not recover since the promisee owed no debt, but as the Restatement of Contracts defines a "creditor beneficiary", the mortgagee might or might not recover, depending upon whether or not the promisee "supposed" that he owed the mortgagee a debt. Of course where both the promisor and the promisee mistakenly believed that the promisee owed the mortgagee a debt, the contract could be reformed, but this is attended with considerable practical difficulties. Of the five possible rules, then, that of the subrogation doctrine and the four of the beneficiary theory, three prevent recovery and two may permit it. But the law of beneficiaries being still in process of growth, it might be well to determine what the rule should be in this

13. 2 WILLISTON, op. cit. supra note 7, § 384. By way of further illustration of the changing law on this subject, see Berick, Personal Liability for Deficiency in Mortgage Foreclosures (1934) 8 U. of Cin. L. Rev. 103, dealing with the law of Ohio, and Note (1939) 25 VA. L. Rev. 993, concerning the law in Virginia.
16. W. Va. Code Ann. (1937) § 5404, which permits one not a party to the contract to sue upon it only when made for his "sole" benefit.
17. Howson v. Trenton Water Co., 119 Mo. 304, 24 S. W. 784 (1893); Hicks v. Hamilton, 144 Mo. 495, 46 S. W. 432 (1898).
21. As intimated above, it is not always clear just where a given jurisdiction stands today. Compare, for example, Keller v. Ashford, 133 U. S. 610 (1890) (leading case on subrogation theory) and Bradbury v. Carter, 291 Fed. 363 (C. C. A. 7th, 1919) (holding that a mortgagee may recover from an assuming grantee, though the latter's grantor was not liable).
particular situation, rather than what it should be for all conceivable contracts.

Assuming, then, that there has not been a mutual mistake of fact, either as to the non-assuming grantee's liability, or the presence of the assumption clause in the contract, what factors should be controlling? Apparently the interests of the mortgagee should be given no weight. In the first place, he already has the security of the land, the mortgagor's personal liability for a deficiency and likewise the personal liability of any other assuming grantees prior to the non-assuming grantee. And most important of all, he has given no consideration for the last and assuming grantee's promise. On the other hand, it must be noted that the non-assuming grantee has given consideration for all of the assuming grantee's promises, of which this is one. And another possibly important factor is that although he has given consideration for this particular promise, he will be unable to recover for its breach since he will be unable to show damage.  

Now it is commonly said that since by hypothesis the non-assuming grantee is not liable to the mortgagee for a deficiency, he has no interest in enforcing the promise of his own grantee to assume. While this may be the usual case, it is by no means necessarily true. It is certainly possible that he intend to provide the mortgagee with additional security for reasons of his own; or again, where he is doubtful as to his own liability to the mortgagee by reason of extrinsic circumstances which might well give rise to a similar doubt on the part of the mortgagee, he is very much interested in making the assuming grantee liable since he might thereby avoid litigation with the mortgagee, which, even though it resolve the doubt in his favor, would be costly in both time and money.

The definition of the Restatement of Contracts of creditor and donee beneficiaries, would permit the mortgagee's recovery in any of these situations, and is for that reason submitted to be the best of the present rules. However, it might possibly permit recovery where the non-assuming grantee is not at all interested in the enforcement of the promise, as for example, where he inserted the assumption clause under a "supposition" of liability which he is now satisfied does not exist. In view of the fact, as suggested above, that it is his interests rather than those of the mortgagee which should be considered, it would seem that in such a situation the mortgagee should not be allowed to recover. While this difficulty could no doubt be met by applying the spirit rather than the letter of the Restatement, the rule that would most neatly fit the facts might be one similar to that appearing in Massachusetts, that one not a party to the contract of assumption in this situation might sue upon it only with the consent of the promisee. However that may be, there is no doubt that, with the trend in the law toward a general acceptance of the third party beneficiary rules of recovery, the law will generally become settled affirmatively at least, that where the non-assuming grantee has any discernable interest in enforcing the promise, the mortgagee will be allowed to recover.

22. To this effect, see Croker v. N. Y. Trust Co., 245 N. Y. 17, 156 N. E. 81 (1927); (1927) 41 HARV. L. Rev. 97. However, though such is the generally accepted dogma, see 2 WILLISTON, op. cit. supra note 7, § 359, n. 1.


24. RESTATEMENT, CONTRACTS (1932) § 133, ib.

25. Id. at § 133, ia.

26. The term employed in the Restatement, § 133, ib.

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DISCHARGE OF THE MORTGAGOR BY RELEASE OF HIS GRANTEE

The importance of the basis upon which the mortgagee sues is most apparent in the situation discussed above, but it has a further bearing in the problem of the mortgagor’s liability where the mortgagee has given the assuming grantee a release or extension of time. Here again the courts are divided, and, broadly viewed, the decisions are based upon one of two theories. The first is to the effect that since the mortgagor and his grantee stand, as between themselves, in the relationship of principal and surety, a release of the grantee-principal discharges the surety.28 The other provides that although the parties may be as principal and surety to each other, nevertheless they are both principal debtors as to the mortgagee, who may therefore treat one as he will without affecting the liability of the other.29 Thus the difference centers about the concept of “suretyship”, and the applicability of a rule of discharge of suretyship law that has not escaped criticism even in the field from which it was drawn.30 Moreover, the analogy is not perfect, since, for example, in the normal transaction giving rise to a surety relationship, the surety makes himself liable for the debt of another, whereas in the mortgage situation, the “surety” is liable for a debt of his own. Again, where release is permitted under the doctrine of suretyship, it is held that it is the mortgagee’s dealing with the grantee which constitutes an acceptance on his part of the suretyship relation; but as has often been pointed out, this is to make the mortgagor a surety and discharge him as such in one and the same act.

It might well be expected that a jurisdiction permitting the mortgagee to sue the grantee only under the doctrine of equitable subrogation would not permit a discharge in this situation on the grounds that the mortgagee’s rights against the grantee are purely derivative, and prior to an action by the mortgagee against the mortgagor there is no duty running from the grantee to the mortgagee which the mortgagee could waive.31 Such, however, is not the case.32 Again, in jurisdictions employing the beneficiary doctrine, the mortgagee’s right against both parties is contractual and direct, and hence dealings between the mortgagee and one of the promisors should have no effect on the liability of the other; but here too the courts do not necessarily carry their rule to its logical conclusion,33 giving more attention to the applicability of the suretyship analogy than to the original basis of liability.

The analogy, of course, should not be permitted to obscure the problem it was designed to solve, and the factual situation to which this analogy to suretyship is applied deserves careful consideration. To say that the parties to the contract of conveyance stand in the relationship of surety and principal, is only another way of saying that the grantor has promised the mortgagee that he will pay the debt, and the grantee has promised the grantor as part payment for the conveyed land, that he will pay off the


29. Iowa Title and Loan Co. v. Cork Bros., 209 Iowa 169, 224 N. W. 774 (1929); and see cases collected in 41 A. L. R. 285.


31. See Union Mutual Life Ins. Co. v. Hanford, 143 U. S. 187, 190 (1892), which apparently recognizes this.

32. "Equitable subrogation" jurisdictions allowing discharge by extension: Herd v. Tuohy, 133 Cal. 55, 65 Pac. 139 (1901); Codman v. Deland, 231 Mass. 444, 121 N. E. 14 (1918); Reeves v. Cordes et al., 108 N. J. Eq. 469, 155 Atl. 547 (1931).

33. Jurisdictions which employ the beneficiary theory yet allow discharge of the grantor: Binga v. Bell, 259 Ill. App. 361 (1930); Harris v. Atchison, 183 Minn. 292, 236 N. W. 458 (1931); Fischer v. Boller, 227 Mo. App. 52, 51 S. W. (2d) 141 (1932).
same amount. Thus there are two separate promises, each for consideration, to pay the sum owed, and the mortgagee may enforce either of them. Now the suretyship rule of discharge of the grantor by extension of time to the grantee was introduced into mortgage law to protect the grantor who was injured by such action on the part of the mortgagee.\textsuperscript{34} It should never be permitted, therefore, to operate so as to release one who has promised to pay the debt and has not been injured by the release.\textsuperscript{35} In other words, the extent of the grantor's release should depend simply on the extent of his actual injury caused directly by the release or extension.\textsuperscript{36} The apparent hardship of such a rule arises where the grantor has come to believe from the mortgagee's dealings with the grantee that the mortgagee no longer looks to the grantor for payment. Yet practically, such an attitude is not justifiable and the fact that the grantor has given a binding promise to pay the debt is the controlling factor.\textsuperscript{37}

What the grantor's injury will be in any given case, is difficult to predict. Ordinarily where there has been an extension of time during which the value of the land declines, the grantor has been injured to the extent of the difference in the value of the land at the time the debt was originally due and its worth at the end of the extension period, since even though the grantor performed his promise to pay and obtained an assignment of the mortgage, he could not foreclose until the expiration of the extension period. But the rule, satisfactory enough in this situation, that the grantor is discharged to the amount of the land's value at the date the extension period begins, is no magic formula invariably producing the perfect solution. By way of illustration, suppose the mortgagee gives the assuming grantee an extension at the time the debt is due, the grantee then owning other property worth the full amount of the debt. At the end of the extension period, the grantee being insolvent, the mortgagee forecloses and the mortgaged property brings only 70 per cent. of the amount of the debt. Now where the grantor could have obtained specific performance of the grantee's promise to pay the debt\textsuperscript{38} in the contract of assumption, it is plain that the grantor's loss of 30 per cent. of the amount of the debt by way of the deficiency he will be compelled to pay has not been caused by the mortgagee's extension, but by his own failure to compel the grantee to perform, due in turn to indifference or carelessness as to his own promise to the mortgagee to repay. In such circumstances it would appear that there should be no discharge whatever.\textsuperscript{39}

In view, then, of the reason for the rule of "discharge by release or extension", it is submitted that what the extent of the discharge will be

\textsuperscript{34} Note (1937) 4 U. of CHI. L. Rev. 469, 470.
\textsuperscript{35} The rule is discussed in Cardozo, The Nature of the Judicial Process (1921) 152.
\textsuperscript{36} Such is the rule for "compensated sureties" [Arant on Suretyship (1931) 299] within which class the grantor here might well be classified.
\textsuperscript{37} As in Morganroth v. Pink, 227 Ill. App. 244 (1932).
\textsuperscript{38} Here, however, the courts may distinguish between a contract in which the grantor merely assumes and one in which he assumes and promises to pay the debt. Woodward v. Molander, 92 Colo. 557, 22 P. (2d) 622 (1933), and Woodruff v. Germansky, 233 N. Y. 365, 135 N. E. 601 (1922), saying that where the grantee merely assumes, the relationship of surety and principal is established between the parties and therefore the grantor cannot obtain specific performance. Thus the surety analogy, designed originally for the grantor's protection, is made to operate to his possible injury. As to the adequacy of the remedy at law, see citations in note 22 supra.
\textsuperscript{39} And a similar rationale was adopted in Iowa Title and Loan Co. v. Clark Bros., 209 la. 169, 224 N. W. 774 (1929) on the ground that the mortgagor could have avoided such loss by paying the debt, obtaining the mortgage and foreclosing immediately in spite of the extension agreement, since the latter did not affect the grantee's covenant with the grantor.
should depend on the circumstances of the specific case, and that the indiscriminate application of any preconceived rule of thumb, that "extension of time to the principal debtor discharges the surety in full", "... to the extent of the value of the land", or "... not at all", will fail to approximate a fair and conscionable settlement.

**The Same Situations in Pennsylvania**

The rights of a third person to sue upon a contract made for his benefit were as obscure and ill-defined in early Pennsylvania law as in that of most other jurisdictions. One of the earliest of such cases was *Blymire v. Boistle* 40 which held that while one for whose benefit a contract was made might sue upon it, yet where the promisee owed the third person a duty which the promise in question was designed to fulfill, the contract could not be regarded as made for the third person's "benefit". Thus, while New York would allow recovery by a creditor beneficiary but not a donee, 41 with this decision Pennsylvania took the opposite position. Nevertheless the *Blymire* decision was not consistently followed, for in subsequent cases the courts recognized the right of a mortgagee to bring an action of assumpsit against the assuming grantee on the latter's contract with the grantor. 42 Thus it appears that whatever may have been the state of the broader contract rule, 43 the rights of a beneficiary of a contract to assume a mortgage debt were not then dependent upon any theory of equitable subrogation.

In 1878 the legislature enacted the following: "A grantee of real estate which is subject to ground rent or bound by mortgage or other encumbrance, shall not be personally liable for the payment of such ground rent, mortgage or other encumbrance, unless he shall, by an agreement in writing, have expressly assumed a personal liability therefor, or there shall be express words in the deed of conveyance stating that the grant is made on condition of the grantee assuming such personal liability: Provided, That the use of the words 'under and subject to' the payment of such ground rent, mortgage or other encumbrance', shall not alone be so construed as to make such grantee personally liable as aforesaid.

"The right to enforce such personal liability shall not inure to any person other than the person with whom such an agreement is made, nor shall such personal liability continue after the said grantee has bona fide parted with the encumbered property, unless he shall have expressly assumed such continuing liability." 44

The effect of this statute was not what might have been expected. Under numerous interpretations thereof, the law today appears to be as follows. The statute is held to have no application in actions by the grantor against the grantee. 45 Accordingly, when the grantee takes "under and subject to" he thereby promises to indemnify the grantor against the latter's actual loss, 46 and the grantee's liability will not necessarily be limited to the value of the land, but is coextensive with the mortgage debt. 47 Be it noted, however, that here the grantor cannot enforce the

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40. 6 Watts 182 (Pa. 1837).
42. Hoff's Appeal, 24 Pa. 200 (1855); Lennig's Estate, 52 Pa. 135 (1866); Merri- man v. Moore, 90 Pa. 78 (1879).
44. PA. STAT. ANN. (Purdon, 1930) tit. 21, §§ 655, 656.
47. May's Estate, 218 Pa. 64, 67 Atl. 129 (1907).
grantee's promise to indemnify until he has first paid the debt or deficiency himself.\(^48\) Where, however, the purchaser takes the land and expressly assumes the mortgage, his promise is construed as one to indemnify against liability,\(^49\) the difference being that the grantor can enforce this promise before he himself has suffered any loss,\(^50\) and may, if he chooses, do so by an action in his own name to the use of the mortgagee,\(^51\) the effect of which is to obtain specific performance of the grantee's promise;\(^52\) and finally, he may enforce the grantee's promise even though the latter has reconveyed the property without expressly assuming a continuing liability.\(^53\)

There have been conflicting opinions as to the effect this enactment had on the rights of the mortgagee, but the law is probably settled today that where the grantee has assumed the mortgage, the mortgagee still has means of enforcing the assuming grantee's promise, and this by an action to use in the grantor's name and with his consent.\(^54\) And in Frey v. United Traction Co., where the mortgagee brought the action in his own name, it was held that this was a mere defect in procedure and that amendment would be permitted then and there and the action allowed.\(^55\) He has never, as yet, been permitted to recover from an assuming grantee who has in turn conveyed the mortgaged premises without expressly assuming continuing liability,\(^56\) but it is difficult to see why an action to use would not be equally effective here.\(^57\) Apart from that limitation, however, the Act of 1878 has been largely circumvented, and since the case of Fair Oaks B. & L. Ass'n,\(^58\) the mortgagee's rights differ little if at all from those of any creditor beneficiary.

Whether or not the statute was given the effect intended by the legislature seems of little importance today. The above rules have grown up over a period of almost 62 years and are not likely to be abjured. This is particularly true in view of the fact that the "construction" of the statute, while curious, is by no means undesirable, in the light of its effect on several correlative problems.

Under this interpretation of the statute, the right of a mortgagee to sue on the contract of indemnity is in all respects save one, that of a third party beneficiary and as indicated above, this is just as it should be. The one possible difference would seem to lie in the requirement in Pennsylvania that the mortgagee maintaining an action to use in the grantor's name, do so with his consent.\(^59\) This point was not mentioned in either


\(^{52}\) Rules 2001 et seq. of the new Pennsylvania Rules of Procedure, Prosecution of Actions by Real Parties in Interest, 332 Pa. lxiii (1939), became effective September 4, 1939. What, if any, effect they will have in the instant situation, this note does not attempt to discuss. They will not, of course, affect any "substantive" rights.


\(^{54}\) See Fisler v. Reach, 202 Pa. 74, 77, 51 Atl. 590, 600 (1902); Smith v. Danielson, 45 Pa. Super. 125 (1911); 2 STANDARD PENNSYLVANIA PRACTICE (1935) 456.

\(^{55}\) 320 Pa. 196, 181 Atl. 775 (1935).


\(^{57}\) (1936) 84 U. of Pa. L. Rev. 910, n. 7.


\(^{59}\) Note 54 supra.
the *Frey* or the *Fair Oaks* cases, but in all probability the court in the latter case would have dispensed with such requirement, since there the application of the rule would have made little if any difference. But it is to be hoped that the rule will not now be ignored entirely. As has been indicated above, the rules of the *Restatement of Contracts* with regard to third party beneficiaries (now a part of the law of Pennsylvania60) provide the best solution to the problem of the liability of an assuming grantee to his mortgagee when the grantor was not liable, save possibly where the *Restatement* would allow the mortgagee's recovery when the grantor had no interest therein. That, however, would not occur in Pennsylvania under the rule that the mortgagee, suing to use in the grantor's name, can do so only with the latter's consent.61 This, then, would appear to be one of the unlooked-for advantages of the Act of 1878 and its operation,62 and it might well be retained by the simple method of requiring a mortgagee who sues an assuming grantee as a *donee* beneficiary to comply with the old rule of consent.

The Act of 1878 has further effect in another unexpected quarter. Where a mortgagor claims a discharge of liability for the mortgage debt on the grounds that the grantee was given an extension of time or release, the Pennsylvania courts have met the question realistically and with a minimum of dogma. Though references to "surety relationship" are not uncommon, it is perfectly plain that the cases turn upon the simple question of whether or not the mortgagee's grant of release or extension was the actual cause of loss to the mortgagor.63 This being the real test, no Pennsylvania cases have allowed discharge, and it is difficult to suppose a situation in which they would do so. By the Act of April 28, 1903, a mortgagor may, by payment of the balance due to the mortgagee, compel an assignment of the mortgage to himself,64 and the courts have maintained, though not in a square holding, that he can "thereafter foreclose as though the extension were not in existence".65 But further, as was seen above, the Pennsylvania mortgagor can, at the time the debt is due, maintain an action in his own name to the use of the mortgagee to compel the grantee's performance of his promise of assumption.66 It is clear enough then, that

61. See note 52 supra.
62. Whether the assuming grantee is liable to the mortgagee when the grantor was not, has been appealed only once, apparently, in Pennsylvania. Merriman v. Moore, 90 Pa. 78 (1879), applying the law as before the Act of 1878. Recovery was allowed the mortgagee on the ground that he was a beneficiary and as such might sue on the assumption contract. Subsequent cases have frequently cited it with approval, but while he would still be allowed to sue, apparently, under the Act of 1878 as applied by the courts he would be obliged to sue in the grantor's name and obtain his consent unless the *Fair Oaks B. & L. Ass'n* case be taken to have dispensed with such requirements.

The manner in which the purchaser of land might properly stipulate in the contract of conveyance that he was not to be liable to pay out money in any event is suggested in *Ledwith, The Personal Liability of the Grantee of Mortgaged Property* (1933) PA. BAR ASS'N Q. 117.

64. PA. STAT. ANN. (Purdon, 1930) tit. 21, §§ 735-738.
66. Note 51 supra. This right corresponds to a surety's right to exoneration, which is enforceable only in equity. *ARANT ON SURETYSHIP* (1931) 318. The right to bring such an action at law may be an unconscious adaptation of an equitable rule by the Pennsylvania law courts, as was very common during the period when courts of equity did not exist in Pennsylvania.
if he fails to exercise either of these rights, any loss he may suffer by reason of a subsequent decline in the value of the property is not the result of the extension, but of his own inaction in failing to perform his own promise. That being so, he is hardly entitled to discharge.

Perhaps almost as much by accident as design, then, Pennsylvania has arrived at what are probably the best possible solutions to the related problems herein reviewed. Its rule of the rights of the mortgagee to sue upon the contract of assumption no longer differs from the modern rule of contract beneficiaries save in one particular that may well prove advantageous, and both these and the rules pertaining to "release by discharge or extension" are admirably unhampered by unserviceable dogma. In view of the fact that the similar law of other jurisdictions is still changing, it may be that in time the results, at least, now reached in this jurisdiction, will be attained more generally in others.

J. R. McC.