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Organizing and Financing Business

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Organizing and Financing Business

With Questions and Problems

by

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SECOND
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Preface to Second Revised Edition

ALTHOUGH it is the intention of the authors in this text to deal with elementary and fundamental principles, changes in business practices resulting from recent legislation and the business depression have made necessary some revision of practices so long in vogue as to be termed fundamental. This has led to extensive revisions of the chapters on "Financing Expansion and Selling Securities" and "Business and the Banks" as well as of many other sections too numerous to mention. Chapter XX on "Business Failures and Reorganizations" has been enlarged to include a summary of the Chandler Act, which is among the most important laws of the century affecting corporations. The chapter arrangement has been changed: "Financing of Real Estate" and "Insuring Against Business Risks" have been placed at the end of the text for better continuity of subject matter. New problems have been added and changes made in the old ones which have been retained. The bibliography has been thoroughly revised and brought up-to-date and a comprehensive index prepared to aid the student and general reader.

The authors wish to express their appreciation to Mr. Edward H. Bishara, of the Department of Banking and Finance, New York University, for his assistance with this and the previous revision.

J. H. B.
L. E. D.

NEW YORK UNIVERSITY

Preface to First Edition

THIS book is intended for use in colleges and universities, in a course on basic business finance, which is to be followed by specific advanced courses in finance, banking, real estate, insurance, investments, and so on; to that end it contains chapters on these subjects preparatory to the respective advanced courses.

It is suitable for use, also, in classes where students are not contemplating taking specific advanced courses in the financial field but desire only a general knowledge of the subjects in the one basic course.

The work is based largely upon an earlier text by one of the authors (*Elements of Business Finance*, by Professor Bonneville), and considerable of the material of that text, which has been used successfully in hundreds of classrooms, has been incorporated. All material so adopted, however, has been reëdited and brought down to date. There have been added a number of completely new chapters embracing such subjects as: Surplus, Dividend, and Reserve Policies, Insuring Against Business Risks, Financing of Real Estate, Financing Expansion and Selling Securities, and so on; these inclusions thus considerably widen the scope of the course.

The text matter is intended to be elementary in character in order to avoid involvements and technicalities which naturally must enter advanced courses in finance. Simple balance sheets and financial statements are occasionally shown, but these do not necessitate a knowledge of accounting as a prerequisite for the course.

In instances where legalities and legal provisions have to be considered, the corporation laws of the State of New York have been taken for the illustrations, because the laws of New York on corporations are very representative and it is impossible in a book of this type and size to give the

varying legal provisions of the many states. Text references cited as "G. C. L." and "S. C. L." mean General Corporation Law and Stock Corporation Law of the State of New York. Instructors in other states can very readily substitute corresponding provisions from their respective statutes.

The Review Questions at the end of each chapter are for the convenience of the student in summarizing the high points covered. The Problems are intended to bring out in case form some of these salient features of each chapter, and around their explanation can be woven most of the instructor's lecture. They also supply suggestions for outside work to be assigned to the student if desired.

The authors have prepared a *Suggestion Booklet* which will be supplied gratis through the publishers, upon request, to all teachers using this text, and to teachers only. This booklet will be found of special help in coördinating the work of the various classes in cases where the course is being given by several teachers in the same institution, and also in supplying standardized solutions to all of the problems.

In order to facilitate the pupil's study, and especially to aid him in review, the experiment of italicizing each financial term and phrase the first time it appears is being tried. It is believed that this method of emphasis will make all new and unfamiliar terms stand out in welcome relief from the body of the text.

The authors wish to express their sincere gratitude for the valuable advice and assistance rendered by Professors Albert F. Chapin, Thatcher C. Jones, Louis P. Starkweather, Currie E. Smith, Saul B. Ackerman, and Nelson L. North, colleagues on the faculty of New York University.

J. H. B.
L. E. D.

NEW YORK UNIVERSITY

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Chapter I

CHAPTER I

Visualizing the Field

General view of the subject.—The organizing and financing of business embraces broad and complicated activities, necessitating wide general knowledge as well as much specialization. A considerable portion of both the general and the special information required may be obtained by careful study, but it cannot be denied that a great deal of actual business ability must come from experience and practice. The course of which this book forms the base attempts to present in a comparatively brief manner those underlying principles which may be acquired by reading and study.

To get at the very bottom of the subject of organizing and financing business, one must have a clear conception, first, of what the term *business* actually embraces and, then, of the details of organizing and financing as applied to it. To that end we begin with a general description of business.

Business.—*Business* is a commonplace enough term, but in taking up its definite study it is well to have a realization of its vast significance. To many it connotes merely the keeping of a shop, large or small; but it must be understood to embrace every human activity whereby man's many wants are supplied. Lumbering, mining, fishing, farming, manufacturing, trading, transporting, shipping, building, merchandising, and many other activities are businesses which help to supply material wants; while law, dentistry, medicine, teaching, accounting, nursing, and entertaining represent a few of the types of business activities which supply desired services.

Business is often divided into two main groups: *industrial business* and *commercial business*. *Industrial businesses* are those which actually produce commodities either by manu-

facture or by some definite treatment of materials, or which produce and supply the raw materials which may be used in their original form or from which marketable commodities can be manufactured or prepared. *Commercial businesses* are those which have to do, not with the actual making of commodities or the procuring of them from nature's stores, but with the distribution of them through various channels from the producer to the final consumer. It must be noted, however, that all commercial businesses do not deal in commodities. Railroad and steamship companies, bankers, brokers, accountants, doctors, lawyers, teachers, and others provide their services instead of tangible commodities, but they are nevertheless rated as in the commercial field. There are, of course, many businesses which partake of the nature of both industrial and commercial enterprises and which must be classified as combinations of the two kinds.

Industrial businesses.—Businesses considered in the industrial field are divided into two subclasses: *manufacturing businesses* and *extractive businesses*.

The *manufacturing businesses* constitute that branch of the industrials which actually produces articles or substances by manufacture or treatment. They represent a very large part of our national business, both large and small, and may range all the way from the smallest individual enterprise up to the tremendous automobile factories and steel mills—corporations with investments of millions of dollars and with tens of thousands of employees.

The *extractive businesses* are those which produce the raw materials with which the manufacturer works or those which are used in their raw state. Examples of the extractives are the various mining industries, the oil-producing industry, lumbering, fishing, and farming.

Commercial businesses.—Businesses of the commercial type are divided into four general types: *mercantile*, *financial*, *transportation*, and *personal service*.

The *mercantile group*, sometimes called the *trading or marketing group*, acts as the distributor of our commodities. It embraces the merchants of every kind—wholesalers, jobbers, retailers—and the middlemen of every kind. These buy wares from the manufacturers or producers, or from

the distributors next above themselves in the line of supply, and then resell the goods to the next below them till the retailer is reached, who in turn sells to the consumers. Some of the members of this mercantile group do not buy outright the goods in which they deal, but handle them on a commission basis.

Financial businesses serve the financial needs of other businesses in many ways and consist principally of such institutions as banks, trust companies, investment bankers, brokers, bonding companies, underwriters, insurance companies, stock exchanges, and so on.

Transportation businesses are those engaged in the carrying of commodities, passengers, and mail. They consist principally of railway companies, communication companies, motor bus and motor van companies, steamship and steamboat companies, and airplane transportation companies. The inland canal and the horse-drawn vehicle are still used in some communities, but they are fast disappearing as transportation factors.

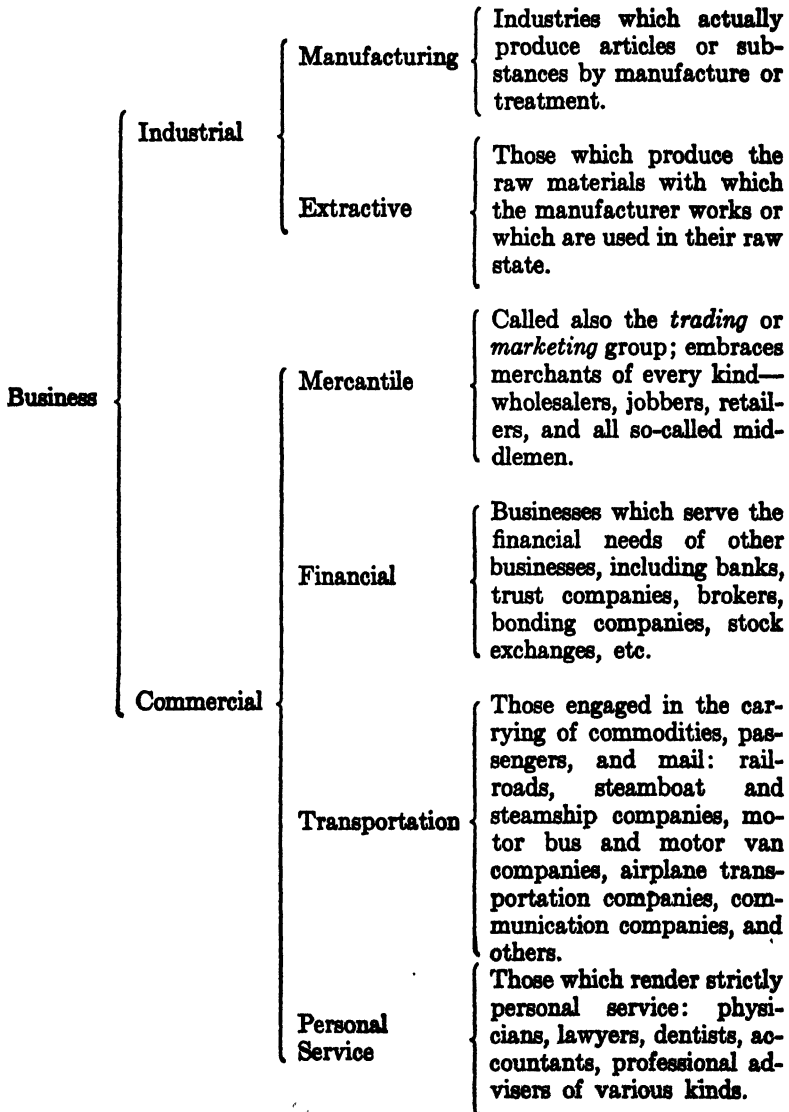
Personal service businesses are those in which personal service only is rendered, such as those of the doctor, the lawyer, the dentist, the accountant, the writer, or any type of professional adviser. Such businesses are practically confined to the professions.

Classes of business diagrammed.—The above-described classification of businesses admits of diagramming which may help the student to fix in mind the classes and their relationships (See page 4).

Purpose and aim of business.—It must be borne in mind that business is not merely a happening; fundamentally it has a purpose, which is the manufacturing, producing, and marketing of every possible article and service that will help supply human wants, and the production and distribution of these in the most convenient and reasonable manner. Without properly organized business, the world today would be without thousands of the everyday commodities which are looked upon as the most common necessities.

The direct aim of the business man is to make a profit out of which to support himself and his dependents and, furthermore, to lay aside savings in as large an amount as possible

Visualizing the Field



to constitute a competence for his retirement or an estate for his family upon his death. He may not fully realize the importance of the economic function of business, but he does understand that the better he serves the public, the better are his chances of success and profit. This perfectly legiti-

mate desire to make money is the urge that impels the business man to drive his business and to make it serve its purpose in the most effective manner.

Incidental to supplying human wants with its products, merchandise, and services, and the owner with a profit, the successful business also furnishes a living to various groups of employees working on either a salary, commission, or profit-sharing basis.

Functions of business.—As may be clearly gathered from what has gone before, business has two great functions which it must perform; namely, production and marketing. These problems are coordinate with, and mutually dependent upon, one another. Production without marketing is useless, and marketing without production is obviously impossible. The proper combination of these two functions, however, gives us our magnificent business system.

One might say that this is all very obvious and that business is, after all, a very simple thing. One should go further, however, and consider that the performance of each of these functions is dependent upon the intelligent operation of scores of lesser, or assisting, functions, which, though subordinate in scope, are indispensable to the proper development of the two essential functions. Among these assisting functions are such things as accounting, advertising, organizing, financing, purchasing, office management, sales management, personnel management, factory and store management, transportation management, and many other activities. Each of these is a complete study itself, and it is upon the knowledge, ability, and skill of the executives and operatives in charge of these and similar departments that the success of a business is largely dependent.

This book is limited in its scope to the treatment of the elements involved in the organizing and financing of business in its numerous forms.

Organizing the business.—*Organization of a business* in this text must be taken to mean the formation or original creation of a business enterprise in any one of its several legal forms, and not the internal or departmental organization for purposes of operation, which is sometimes referred to by this phrase.

Faced with the problem of starting or organizing a new business in any particular line, the organizer must first select the form of business organization which he will use. In this matter there is a wide choice; the principal forms will be discussed in detail in Chapter III.

Financing the business.—*Financing* consists in the raising, providing, and managing of all the money, capital, or funds of any kind to be used in connection with the business. It is necessary throughout the activities of promotion, organization, regular operation, reorganization, and readjustment of business. It must take care of all the financial needs of the business and involves a knowledge and use of money, credit, securities, funds of all kinds, financial legislation, financial usages, and financial management. It embraces a systematic control and regulation of all capital revenue and expenditures.

There are two quite distinct fields of finance—so distinct as to form entirely separate studies—namely, *public finance* and *private finance*. *Public finance* is concerned with the procurement of money for the use of government—local, state, or national—and with the administration of public funds; while *private finance* is concerned with the monetary affairs of privately owned enterprises only. Political entities have the power to raise money by levying taxes and enforcing their payment; but private enterprises, of course, have no such power and can raise funds only by selling ownership in the business or by borrowing. Public finance is left to other texts, this work being restricted to private finance exclusively.

Interrelated subjects.—The study of Finance is most intimately related to that of Economics, Accounting, Business Law, and Business Management. These five subjects overlap and interlace so persistently that it is impossible to go into any one of them without penetrating to a considerable extent into the other four. We shall not in our present study of the organizing and financing of business slight any principle of economics, fact of law, feature of accounting, or rule of management which may be necessary for an understanding of our subject, but we shall touch on them as lightly as possible and in a purely non-technical manner, leaving the

exposition of these subjects to their proper courses and textbooks.

Preliminary definitions.—As we go on in the study of Finance, we shall come to hundreds of names and terms more or less peculiar to the subject and shall learn the significance of each in turn. There are a few basic definitions, however, which we must have at the very start in order to lay a working foundation. These are the terms: *funds*, *credit*, and *capital*; and each will be described briefly.

Funds.—*Funds* constitute the prime requirement in starting and operating any business enterprise, and by far the largest part of all financial activities consists of the raising and management of funds.

The word is commonly defined as:

(a) "Cash or its equivalent; that is, checks, drafts, money orders, and so forth. The term may be used to include securities which have a ready market and which can be quickly liquidated. It is common to hear the expressions 'liquid funds,' meaning cash, and 'tied up' funds, meaning money invested in income-bearing assets."¹

(b) "A *fund* is a collection, or store, or amount of something by means of which purchases and payments may be made. The word *funds* signifies any and all things which may be currently used in a community in exchange for goods or property of others."²

(c) "*Funds* include all the instruments and instrumentalities whereby the exchange of goods is facilitated, and include money, credit money, and credit."³

A useful diagram showing the divisions and subdivisions of funds along this line is to be found on page 8.

Credit.—*Credit*, which is one of the subdivisions of funds, is the ability to buy with a promise to pay; that is, to receive goods or services and obtain title to them at the present time, although the actual payment is deferred until a future date. Concisely expressed, "*Credit* is the power to obtain goods or services by giving a promise to pay money on demand or at some specified date in the future."⁴

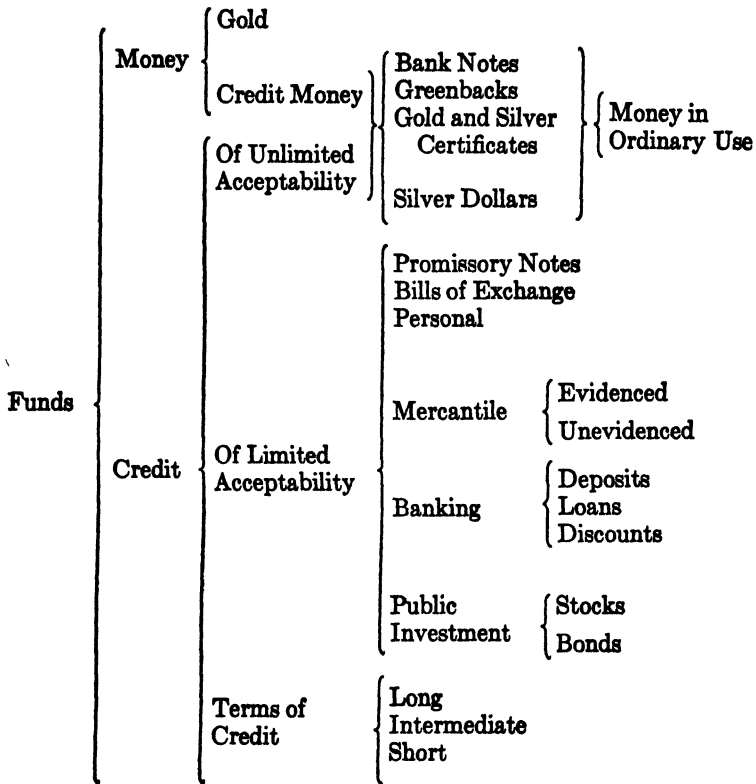
¹ Munn, G. A., *Encyclopedia of Banking and Finance*.

² Cleveland, Frederick A., *Funds and Their Uses*.

³ Gerstenberg, Charles W., *Financial Organization and Management of Business*.

⁴ Johnson, Joseph French, *Money and Credit*.

Visualizing the Field



Modern business is conducted very largely on a credit basis. In a complete transaction, such as the production and marketing of a given article, there are many processes which consume considerable time, and it is only the continuous and successive passing and acceptance of credit all along the line that enables the various business houses involved to carry out their respective parts. A diagram of the kinds and types of credit is shown above, but a few words of explanation are probably in order.

Personal credit, as the name implies, is the credit used by an individual but not in a business capacity. The credit on which one carries a monthly account with the grocer or butcher is usually based solely on one's personality. Likewise, a person's ability to borrow small amounts at the bank on an ordinary note is due to his personal credit. As we shall

see later, the credit of a partnership is often based largely upon the personal credit of the members of the firm rather than upon the business strength of the firm itself.

Mercantile credit is that employed in general by business firms of all types in carrying on their activities. It aids in all production, manufacturing, and mercantile transactions from the time raw materials are gathered till the time the finished product is received by the retailer. This mercantile credit may be *evidenced* or *unevidenced*.

Evidenced credit means credit in which the creditor holds some kind of document or paper from the debtor acknowledging the debt or promising to pay. Holders of such credit instruments may frequently negotiate or discount them before maturity, thus making available to themselves the cash represented by the credit item, less interest to maturity.

Unevidenced credit is credit in which the creditor has no credit instrument but rather carries the claim as an open account. He expects to collect it at the end of the credit term, or he may assign or sell the account before that time.

Banking credit consists of the deposits, loans, and discounts of a banking house.

Public credit is that enjoyed by any political entity.

Investment credit is represented by bonds. Bonds are promises (of either corporate or public borrowers) to repay specified sums of money at some future time.

Giving and accepting credit.—A very widespread misuse of terms in speaking of credit necessitates a caution to many to remember that credit always *passes* from the debtor to the creditor, from the buyer to the seller, and never in the opposite direction. Simple as this may seem, we hear constantly such expressions as "Mr. Goodpay did not wish to be bothered with paying cash for daily purchases so the grocer *gave* him credit," or "Mr. Citizen *asked for* credit at his clothier's, and the clothier was glad to *give* it to him." Constant usage should not be allowed to justify such incorrect expressions as these. As a matter of fact, Mr. Goodpay and Mr. Citizen *possess* credit (that is, the ability to buy on a promise to pay later rather than to buy for cash), and they part with a portion of their credit to the merchants when they buy from

them on credit. The purchaser *offers* credit, and the seller *accepts* (or declines to accept) credit. This holds, of course, in all transactions, large and small. The debtor redeems his credit, or that part of it with which he has parted, when he pays his bill.

Albert F. Chapin in his work, *Credit and Collection Principles and Practices*⁵, expresses this idea authoritatively as follows:

"It is . . . in accord with the more general view to regard credit as a power possessed by certain individuals which is not limited by the extent to which it is used. Indeed, we may go a step farther and say that credit is a power possessed by everyone, a power which varies among different individuals (and corporations) from indefinitely great to nothing. Credit, therefore, is not a quality bestowed on one by another; it is not *given*; it is not *granted* except in the sense that by "granted" we understand that it is *conceded* to be. It is a quality which we recognize and appraise just as we recognize and appraise, but do not bestow, the quality of beauty. . . . The borrower does not really ask for credit; he offers credit, and it is accepted or rejected by the lender according to whether or not the credit is appraised as sufficiently high."

Capital.—The term *capital* has been used by economists, accountants, and financiers in so many cases and with so many shades of meaning that it is practically impossible today to apply to it any fixed definition which will apply in all cases. From the general point of view, however, capital means all the property of every kind employed by the business, though most business men would express it as the total ownership in the business, consisting of the amount invested, the surplus, and the undivided profits. The former description leans more toward the economic idea and the latter more toward the accounting idea, but each expresses in its own way the financial meaning of the term.

The word *capital* must not be confused with *capitalization* and *capital stock*, which indicate quite different things, as will be shown later.

Capital property.—*Capital property* is a term generally used to designate property of every type which constitutes a part of the capital of any enterprise. It may be viewed as

⁵Page 5.

comprising two kinds: *capital goods* and *capital rights*. *Capital goods* consist of cash, buildings, real estate, inventory, equipment, machinery, rolling stock, and other such capital property. *Capital rights* embrace stocks, bonds, notes, and securities in general which are not goods in the true sense but which carry the rights assigned to them and which are normally convertible into goods (usually cash) either by redemption or sale.

Capital value.—The term *capital value* explains itself, but attention must be called to its several types and subdivisions.

In any company which has been in operation to any extent, there is, or should be, a great difference between the original capital value and the present capital value. The former represents the capital value at the inception of the business; the latter at the present time. It is well to note also that there is a distinction made between the *nominal* and *actual* original capital value. Nominally, the original capital value is the authorized par value of all stocks and bonds of the company; but the actual original capital value is, of course, the amount actually paid in on these securities. The present capital value consists of the stock and bonds (original proprietorship) in addition to the existing surplus (the increase in original capital being used for capital purposes).

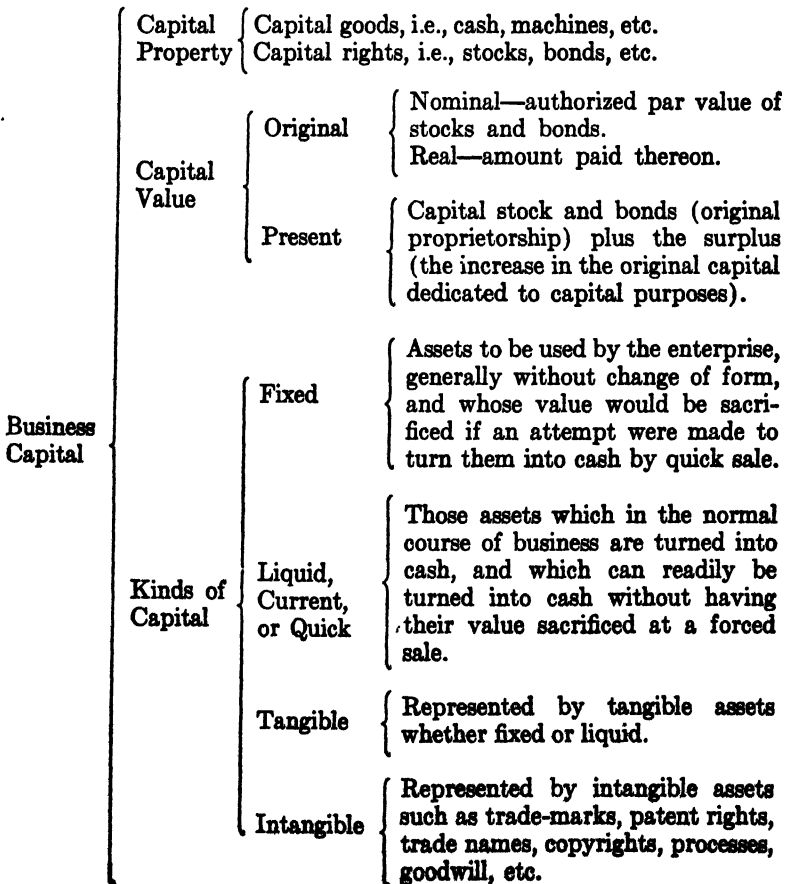
Fixed and liquid capital.—*Fixed capital* is capital represented by fixed assets; that is, assets to be used in the conduct of the business generally without change of form: non-trading assets, such as land, buildings, equipment, machinery, furniture, fixtures, and so on. These assets are of a permanent nature and in the ordinary course of business will not be converted into cash; their value would often be sacrificed if the attempt were made to convert them into cash through quick sale.

Liquid capital, known also as *current*, *quick*, or *fluid capital*, is capital represented by cash or other assets which in the ordinary course of business will be converted into cash, and which ordinarily can be converted into cash by a quick sale without having their value greatly sacrificed. These liquid assets, other than cash, consist of such things as raw

materials, finished goods, accounts receivable, notes receivable, and so on.

Tangible and intangible capital.—Capital may also be classified as *tangible* and *intangible*. *Tangible capital* is, of course, all that capital, whether fixed or liquid, which is represented by some tangible asset, such as real property, equipment, cash, inventory, accounts receivable, and so on. *Intangible capital* is that represented by such things as patent rights, copyrights, trade-marks, secret processes, and goodwill.

Capital diagrammed.—For convenience in study, business capital may be diagrammed as follows:



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Questions for Study and Review

1. What is meant by the term *business* in the broad sense?
2. Distinguish between industrial and commercial businesses, and give the subdivisions of the two classes.
3. Distinguish carefully between the economic purpose of business and the immediate aim of the business man.
4. What is meant by the term *financing a business*?
5. Distinguish between public finance and private finance.
6. Define and discuss the term *funds*.
7. Define the term *credit*, and discuss its classes and uses.
8. Who gives credit, and what induces its acceptance?
9. State what you believe to be a proper business concept of the term *capital*.
10. Discuss capital property, capital value, and the kinds of capital.

CHAPTER II

Starting a Business

Preliminary consideration.—The economic organization of society today is such that no one person can produce or supply all of his own needs. The resulting condition is a wide division of labor and much specialization in industry, and all persons are working for money, which is universally exchangeable for any products which they may need. The great majority of the people are employed on a salary or wage system, but many, nevertheless, must organize and operate businesses, in order that such employment may exist. Of the great numbers of persons who go into business for themselves, however, only a small number, estimated by various economists at from ten to twenty per cent, meet with sufficient success to enable them to remain in business, while the remainder make failures of their attempts.

Practically all of these failures can be attributed to a lack of business knowledge on the part of those concerned. If they knew enough of business principles and methods, the majority of them could see that the business on which they propose to embark will not succeed because it will not serve a public demand great enough to insure sufficient return to pay all operating expenses, interest on all capital invested, and beyond this a satisfactory profit to the owners of the business. If, however, their venture should be into a field of sufficient demand, failure is usually caused by lack of managerial or financial knowledge and ability.

Making the decision.—The problem, then, which faces everyone fired with the urge of starting a business is primarily whether or not to enter business at all, and secondarily, if he does enter, what type of business he will choose. The question is, in many cases, solvable only by a trial. In the great majority of instances, however, those trained in busi-

ness fundamentals, such as production, marketing, and finance, can, upon investigation, make a fairly accurate estimate of the probability of success in any business proposition.

First of all, it must be remembered that all business consists in supplying human wants or needs, and the prospective business man must determine whether the goods which he proposes to manufacture or deal in are those which people want or may be made to want; that is, whether there is an existing demand or the possibility of creating a demand. If it can be shown that there is a demand of substantial size, it must then be determined how well that demand is already being supplied; that is, what competition will be encountered. Suppose that in a certain town there is just sufficient demand for shoes to support four existing shoe stores. The opening of a fifth will indeed be a hazardous undertaking. If the trade is divided into five parts instead of four, no one of the shops will be making a profit, and the one with the least reserve power, capital, or general ability must fail. This usually means the failure of the new concern rather than that of one of the four old, established ones. If, however, the new store is greatly superior to the older ones, having better goods, better service, more modern and attractive equipment, a better location, more convincing advertising, and so on, it may well attract from the other shops sufficient of their trade so that it will succeed while one or more of the older ones must fail.

But even in the event of ample demand with inconsiderable competition, it is highly unwise to enter business in any field without a fairly sound knowledge of business and business principles. In the not far distant past it was generally believed that this essential knowledge could be obtained only by experience and hard knocks. Today, however, experience is bolstered up by scholastic study, and it is the combination of the two which creates successful business men. The men and women who are today occupying positions in the business and commercial world and who at the same time are taking the well-designed business courses of the schools of commerce of our universities and colleges are without question destined to make our great business leaders. These

schools are finding that their best students are those who are working while taking courses or who have already had experience, and the business world is realizing that the university students and graduates are to a greater and greater degree becoming the most able and dependable executives.

When one has gained a fair amount of business knowledge, the secondary part of the problem arises: What field of business shall be chosen? While a general knowledge of business and its principles is helpful in any field, it is generally pretty hard for anyone to succeed in a business when he is unfamiliar with its particular processes and peculiarities. Ordinarily one will do much better in a field in which he has acquired detailed knowledge and experience. If one had been working in the building contracting business for a number of years, not only would his natural tendencies urge him to enter that or some kindred field, but he would be much better prepared to make a success of it than he would of a banking house or a retail store. There are thousands of little details of information, "tricks of the trade" so called, which come only with experience and without which success is doubly difficult. In the great majority of cases it is the experienced shoe clerk who opens the new shoe store, the assistant pharmacist who starts the new drug store; the customers' men, economists, and experienced salesmen who organize the new brokerage firms; and so on. But for the operation of this natural tendency which brings into business men who are well experienced in the many fields, there would undoubtedly be many more failures than there are now.

Promoting a business.—Business does not spring, Athena-like, fully formed from the brow of some commercial Zeus, but comes into being only after the painstaking performance of many preliminary activities. All of these numerous things which have to be done in order to bring a business into existence are known under the general name of *promotion*. This term embraces such activities as the careful investigation of the proposition to determine the probability of its being profitable, and the amount of funds that will be neces-

sary to start it on a sound basis; the making of all necessary contracts and obtaining of options necessary to begin operations; the acquiring of the property necessary for the business; the determination of the methods by which the necessary funds for the business shall be raised; and, in most cases, the actual raising or procuring of the funds themselves.

The person by whom this important work of promotion is done is known as a *promoter*, whom we shall treat more in detail later in this chapter. Very often the man who conceives a business for himself acts as his own promoter; in other cases he turns the promotion work over to some person or firm highly skilled and practiced in this type of work; while, in still other instances, men of ability conceive and promote propositions with the sole idea of disposing of them to others, taking as their recompense either a cash fee or a part ownership in the business when formed.

The work of promotion may for purposes of study be divided in many ways, but for our elementary study it will be treated under three main divisions; namely, *discovery*, *assembling*, and *financing*.

Discovery.—The word *discovery* as applied to the first step of financial promotion in business means more than simply finding what appears to be a good opportunity to start an enterprise; it means more nearly the uncovering of the entire proposition through careful investigation, and the determining whether or not the proposition should be undertaken. To indicate the feasibility of the proposition, this discovery must ascertain whether or not the business will be profitable, how profitable it will be, and the amount of funds necessary to inaugurate the business.

Let us suppose that we have conceived the idea of promoting and organizing an electric light and power company in a small city which is without electrical service. The first thing to be done is to ascertain whether the city will grant our company the franchise or permit to operate the business within its limits and what the terms of such a franchise would be. It is important that we obtain in so far as possible an exclusive franchise for a considerable period of time in order to prevent undue competition which the community

cannot support without very high rates. If the matter of franchise rights can be satisfactorily arranged, we can proceed with the other steps of the discovery.

We must first ascertain all costs of construction and equipment, including power houses, machinery, engineering work, erection of poles, construction of underground conduits, stringing of wires, connections with houses, setting of meters, purchase of all materials, erection of substations, offices, workshops, purchase of repair trucks, and so on. To this we must add the cost of making the investigation, the cost of real estate and rights of way to be procured, the contractors' profits, the expense of the company organization, the interest on the money involved, and the taxes and insurance during the time of construction when no income can be expected. Before the business can begin to yield, we must also have had considerable working capital to carry it along for some time and must also have spent considerable money in establishing the business, or making it self-supporting, a phase which will be taken up later. The cost of these and of innumerable smaller details added together will give the amount of funds necessary for the starting of the proposed business.

The promoter must then make a most intensive research into the possible income from the service to be rendered by the company. He shall ascertain how many households, shops, factories, churches, theaters, and so on, will use the lights, the total consumption of current by them, and the income from this source. He will similarly determine the income from current sold for power to factories, garages, shops, household utilities, and so on. In all probability he can count on considerable revenue from street and park lighting and from electric signs. Possibly he can count on income from similar service to neighboring communities.

This carefully estimated total income must be offset by the total operating and upkeep expenses, together with the necessary interest on capital involved, taxes, depreciation, and so on, to show the estimated profits of the company. If these profits are unquestionably sufficient in amount to constitute fair earnings on the investment, the promoter may proceed further with his organization; otherwise, it should be dropped at this point.

It can readily be seen how important this discovery is and how much depends upon the skill, knowledge, experience, ability, and honesty of the promoter who is doing it. A comparatively slight miscalculation on any one of the elements involved may cause the entire findings to be wrong and may induce large investments in a profitless enterprise or the condemnation of one which is essentially sound.

Assembling.—This second step in promotion embraces the various activities necessary to begin operation and should not, of course, be carried out unless the result of the first step, discovery, is favorable and shows that the proposed business has a fair chance of success. In the case of the proposed light and power company mentioned in the preceding paragraph, the *assembling* would in large part consist of actually obtaining the franchise; making of the contracts for all construction work, supplies, buildings, machinery, and so on; and obtaining all necessary options on real estate and right of way. Every preparation must be carefully made so as to show the proposed future investor in the proposition that immediately upon the raising of the capital, the construction and operation along the previously arranged plans can go along without a hitch. Suppose that at one particular place it is absolutely necessary for the transmission lines to turn out from the highway and to cross private property, and that the promoter has neglected in his assembly to obtain from the property owner an option on the right of way through the property. This might have been overlooked by everyone concerned until the construction of the lines was well under way and had reached the property in question. We may feel well assured that at this point the property owner would intervene. The matter might be easily adjusted, but the history of such affairs indicates that the owner would more likely attempt to charge the company an unduly large amount for the privilege desired, thus causing either large and unexpected extra cost or long and expensive delay during negotiations or probable condemnation proceedings. Oversights smaller than this in the matter of assembling have caused the failure of many, many plans.

Financing.—When the discovery and assembling have been accomplished, it devolves upon the promoter to arrange

for the *financing* of the proposition—that is, to devise and plan the method of raising funds necessary for starting and carrying on the business—and, often, the actual raising of the funds.

A promoter's activities may be centered in developing an entirely new proposition, or else in arranging for some kind of combination of several existing companies or for the purchase or lease of some company's property. In either case he must, of course, make careful discovery and complete assembly along similar lines, but the financing of the two kinds of propositions are along quite different lines. The financial arrangements for the purpose of consolidation, merger, sale, or lease will be discussed later, and the financing spoken of in this chapter will relate to that of a new enterprise. If the business under consideration is comparatively small and the promoter is working it up as a private business for himself, using his own funds to start it, no question of the method of raising capital is involved: he simply puts into the business the money he has saved for the purpose.

It often happens, however, that the discovery shows the proposed business to be a bigger financial burden than the promoter can carry, and in that case he may wish to acquire one or more partners to invest with him. His sole financing problem here is to find persons satisfactory to him who can be induced to invest the desired amount in the partnership.

The term *financing*, as usually applied to the promoter's activities, however, really refers to his work in devising methods of raising funds for the larger enterprise, which will in all probability be organized as a corporation, or some similarly financed firm, such as a joint-stock company or a business trust.

Financing an enterprise of this sort contemplates raising funds for three distinct purposes:

1. *For financing during the organization*, or meeting the cost of all intangible property from the very start until the time when the business is in actual operation. This embraces expenses for such things as investigation of the project; procuring parties who may be willing to participate; preliminary engineering and legal advice on the project; a

canvass of territory to ascertain whether sufficient business can be obtained; an estimate of the cost of the plant, the income, and the profit; the incorporation of the company; and the securing of the franchise. The funds for this purpose are usually advanced by the promoter himself, and unless he is successful in his promotion project, this provision may entail considerable loss for him.

2. *Financing the construction*, which means meeting the cost of all the tangible property. This embraces the cost of real estate; labor, materials, and contractors; engineering; the expense of company organization during construction; the interest during construction; taxes and insurance during construction; stores and supplies; working capital; legal expenses; and the expenses of financing, including bankers' commissions, discounts on bonds, and the promoter's profits.

The proceeds from the sale of stocks and bonds of the company are properly used to defray this expense.

3. *Financing the business*, which means the cost of acquiring or establishing the business and includes such charges as advertising; canvassing for business; interest on the cost of the plant in excess of income until the business becomes self-supporting; and taxes and insurance during that time.

The funds for this purpose may also come from the sale of the company's securities.

Methods of financing.—In making his plans for financing a proposed business, the promoter is limited to a choice between only two means. He can sell part ownership in the business, or he can have the business borrow money for its capital. Generally he devises a plan consisting of a combination of these two.

The person promoting and organizing a business entirely for himself contributes his own savings, thus, in effect, selling the entire ownership of the business to himself. If he takes in partners, he sells to them a part of the ownership.

Passing these simple affairs for the moment, let us consider the problem of the promoter of a company which is to be a corporation, or one of its substitutes, a joint-stock company or a business trust. When he sells ownership, he sells shares in the business and the buyers are given certificates of

stock indicating their ownership. When he has the business borrow some of its capital, the lenders are issued certain instruments acknowledging the loan and promising to repay it at a certain time. These are *bonds*, and this process of borrowing money for a company is known as *selling its bonds*.

✓ The promoter must decide the total amount of capital to raise, how much to raise by the sale of stock, and how much through the sale of bonds. He thus devises what is known as the *financial plan*, and the financing of the promotion as well as the future success of the business itself depends very largely upon the judgment and ability he displays in forming this plan. If financing is on the basis of a public offering, he will undoubtedly receive assistance in working out his plan from the bankers who will handle the security issues. The methods of laying the financial plan are described in detail in a later chapter.

The promoter.—The promoter occupies a most important place in the financial and business world. His work of visualizing new organizations to serve business needs, and combinations of existing businesses to work in a more economical and profitable manner; his investigation and assembling of these propositions; and finally his work of actually bringing them into being by obtaining the interests of bankers, financiers, and the investing public—all these are activities without which the business world would soon stagnate.

The name *promoter* has been much abused and most people inexperienced in financial matters associate the word with a smooth individual trying to sell stock in some fraudulent plan or get-rich-quick scheme. Of course, there are plenty of such people who call themselves promoters. There have been cases where the public has been defrauded out of millions of dollars through the sale of stock in non-existing rubber plantations, gold mines devoid of gold, and building developments under water at high tide. The stories one hears of selling to visitors stock in Brooklyn Bridge, Central Park, or the Woolworth Building in New York for varying amounts are not at all fairy tales. These things have actually been done a number of times, and the men who do them are self-styled promoters. They are, of course, merely confidence men and swindlers. The legiti-

mate promoter is in no way to be confused with them. To be successful a promoter must be capable, honest, and honorable. His entire stock in trade consists of his business ability and his reputation for successful and honorable promotion in the past.

The great majority of all business propositions are promoted by bankers, lawyers, engineering firms, and business executives, who frequently are the originators of the ideas and, also, the ones to whom clients and friends bring their ideas to be materialized. These are known as *occasional promoters*, as distinguished from *professional promoters*, who devote their entire time and energy to promotional work.

The prospectus.—In the promotion of a small business, the preparation of a formal written statement detailing the results of the discovery, advantages of the proposition, probable profits, and so on, is not necessary, as such details are presented orally to those whom the promoter desires to interest. Such a statement when written out in detail is termed a *prospectus*, and is usually designed to present the proposition in the most favorable manner possible in order to interest people in investing in the proposition. In a business where it is planned to sell securities directly to the public without the aid of an investment banking house, a prospectus would in all probability be written in general terms and resemble more a good sales letter than a technical discussion, leaving it to a follow-up by a salesman or correspondence to cover any inquiry for further details. Where, however, the sale of securities is handled by an investment banker, a complete prospectus substantiated by whatever supporting data are available will be expected, and in many cases experts in the employ of the banker will check up on the statements contained therein.

The Federal Securities Act and some state statutes prescribe penalties and liabilities for careless and misleading statements and omissions.

Promoters' profits.—Successful promoters receive large remuneration for their work. This remuneration is usually, however, stock in the company which they are promoting; so that if the business is not a success, their stock amounts

to nothing unless they sell it at a good figure before it is ascertained that the business will not pay. If, however, their venture succeeds, they have a block of good, marketable stock.

Many persons have complained that the large blocks of stock usually given promoters are out of proportion to the services rendered. In some cases this may be true; but these promoters are paid not alone for their services but also for the financial risks which they take. A promoter may spend from his own pocket thousands of dollars in investigating a proposition, only to find eventually that it is unsound. This expenditure, then, is a total loss to him. He cannot insist upon cash for his services rather than stock, for that is immediately construed as an evidence that he lacks confidence in his proposition. Hence he accepts stock in full payment for cash advanced and for services, and it may be several years before he can dispose of the stock to advantage.

Status of the promoter.—The promoter occupies a rather peculiar position in relation to his proposed company and the prospective stockholders. He is not an agent of the company, because it does not exist, yet most of his acts are like those of an agent. He is legally considered to act in a fiduciary capacity for the corporation he is about to form. The acts and promises of the promoter prior to the company's organization do not bind the corporation, although the latter upon organization may adopt them. The promoter's relation of semi-trust with the company prohibits him from making a secret profit. Profits are permissible if they are made with the knowledge of the corporation. To avoid an accusation of secret profits, the promoter must make an *actual, full and frank* statement of the profits made on any contract between himself and the corporation. *Actual* means that mere intent not to conceal or refraining from concealment is not sufficient disclosure of facts. *Full* requires a specific statement of the amount of profits. A statement, for example, that the promoter is making or expects to make a profit will not suffice. *Frank* requires that the actual facts be given, not merely how or where they may be obtained.

If a promoter is discovered to have violated his trust and

to have made a secret profit at the expense of the company, the latter may repudiate all dealings with him and rescind the contract. It often happens, however, that the contract is too valuable for the company to give up; in that case, the company may affirm the contract and sue the promoter for any damage resulting from the abuse of his fiduciary power. Often the matter is compromised by the company's affirming the contract but taking over from the promoter his secret profits.

After the company is properly organized and doing business under the bona fide board of directors, the promoter is no longer bound by his fiduciary relations with the company and may deal with it just as may any outsider. Whatever he does from this point on is usually called *dealing with the corporation at arm's length*.

Relations between promoters.—Several persons promoting the same proposition are not ipso facto partners. They may, of course, form a partnership for the purpose, but they are not to be construed as partners simply because of the fact that they are joint promoters of the same company. This is very important in connection with liability for indebtedness or damages (See Chapter III on partnerships).

Promoters are not compelled to carry a proposition through to completion but may give up the organization at any time, provided they do not violate an agreement among themselves. It is, in reality, the duty of every promoter to give up immediately the promoting of any business that he finds will be unprofitable. This abandonment, of course, will generally entail upon him considerable loss on account of cash advanced to carry on preliminary stages of promotion. Some unscrupulous promoters will therefore carry the proposition along until they can unload it on someone at a price which will enable them at least to break even.

Summary.—The prospective business man, then, if he wishes to have a fair assurance of success, should have at least some business education and experience and some specific knowledge of the field he expects to enter. Many who do not have these qualifications attempt to compensate for their lack of training by employing trained and experienced managers. While it is sometimes possible to succeed by this

method, hired brains rarely take the place of proper business knowledge on the part of the principal, and a business so conducted often fails before the owner has been able by association and practice to develop sufficient ability to conduct the business himself.

He must know the great importance of proper promotion, especially the preliminary investigation. He must decide whether he has the ability to do this promotion work or whether he must trust it to another. In case he decides on the latter course, he must know just what to expect from the relationship and must exercise the keenest judgment in selecting his promoter.

He must know, also, which *form* of business organization, as listed in Chapter III, is best suited to the needs of his business, and he must select the most desirable one. The next four chapters are devoted to a somewhat detailed description of these various forms of organization, showing their several characteristics and their advantages and disadvantages.

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Questions for Study and Review

1. Would a more general knowledge of business principles and methods tend to reduce the percentage of failures? How?
2. Explain the importance of choosing a business which will fill an economic demand.
3. What is meant by the term *promotion*?
4. Name and explain the three steps in promotion.
5. Before advancing beyond the discovery step in promotion, and especially before attempting to raise funds for a proposed enterprise, of what should the promoter give unquestionable assurance?
6. Name and explain the three purposes for which initial funds are raised by the promoter.
7. In how many ways can funds for an enterprise be raised? What are they?
8. Discuss the importance of the promoter's position.
9. Discuss methods of the remuneration of promoters.
10. Discuss in detail the topic "Secret Profits by Promoters."
11. Are joint promoters of the same proposition partners?
Discuss.

Problems

1. Mr. X, a young man twenty-six years of age, who has been employed as a salesman in a retail furniture store for eight years, ever since he was graduated from high school, has saved \$3,000 and has just inherited \$10,000. He does not like the furniture business and is anxious to open a retail book store. As an expert business adviser, give him your opinion and advice, with reasons.

2. Mr. X (above) has started his retail book business as an individual proprietorship and has made a satisfactory profit for three years. He convinces you that with increased capital to enlarge his business he could do a great deal better. Advise him in detail how he could raise funds, and give the reasons for and against the methods suggested.

3. Mr. Crooks and Mr. Wright are promoters of a copper mining proposition. Mr. Crooks sells a large block of the stock to Mr. Marks, representing to him that the mine has a shaft sunk to producing lode and is mining and shipping ore. This report is not true in any respect. The company soon fails, and Mr. Marks loses all the money he invested. Explain his rights and chances of recovery.

4. Mr. Smart is promoting a land development company. He sees an opportunity to buy at \$10,000 a piece of property which he knows his company wants. He buys it personally at this price and resells it to the company at \$12,000, making no statement as to the cost price. The company later learns the facts of the transaction. What steps can it take to rectify the loss, and what do you suggest as the most effective procedure in the matter?

5. Mr. Cash owned a large piece of land in the path of a suburban development. He began the promotion and organization of a development corporation to take over his property. At the end of two years of promotional work, the corporation was completely organized and operating under its own board of directors. Mr. Cash paid for his land \$15,000; at the time he began the promotion of the company it was worth \$22,000, but when the company was fully organized it had increased in value to \$25,000. If Mr. Cash and his company had not agreed upon any price at which the company could take over the property, what could Mr. Cash legally charge the company for the property (a) if the corporation took it over during the period of promotion; (b) if it were not taken over till after the corporation was completely organized and doing business under its own board of directors?

CHAPTER III

Choosing the Form of Business Organization

Forms of business organization.—Probably the first business was founded in some prehistoric time when one who had more of something than he needed bartered it for some other article he desired. Eventually certain articles desired by everyone, and thus having general acceptability, were adopted as a medium of exchange. Then those who had acquired, or who had manufactured, articles in excess of their own needs sold their products, taking some medium of exchange—usually gold, silver, or some baser metal—in return. The step next taken was the acquisition of goods by those possessed of funds, to be resold at a profit, and we have the foundations of business as it exists today. The first type of business organization was the individual proprietorship, where one person owned his stock of trade or conducted his crude manufacturing entirely for his own profit. The individual proprietorship as a form of business organization is the most common of all today; its simplicity recommends it for the small business.

But as soon as men began to combine their abilities and capital in various undertakings, other forms of business organization developed. Originally, some of the forms may not have borne much resemblance to what they are today, for the process was one of evolution with adaptations to our ever-changing economic environment.

In this and succeeding chapters, we shall study those forms which are in use today. They are:

1. Individual proprietorship.
2. General partnership.
3. Limited partnership.

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4. Joint venture.
5. Joint-stock company.
6. Limited partnership association.
7. Massachusetts Trust.
8. Corporation.

The student may well wonder why it is necessary to have so many forms of organization, but as we undertake the study of each it will be seen that they represent merely a desire on the part of business men to find a means of obtaining for each participant the desired proportion of income, risk, and control of the enterprise.

Factors in choosing a form of organization.—No form of business organization yet devised is equally satisfactory for all businesses. All have certain advantages and disadvantages, though even this classification of their characteristics is one that cannot be strictly accurate. A characteristic that is a disadvantage from the standpoint of one business may be a distinct advantage from the point of view of another. When facing the problem of deciding what form is best for a certain business, the size of the business is often the determining factor, because that one point may narrow the choice to two or three of the forms. However, in studying the various types of business organization, a consideration of the following questions with regard to the characteristics of each will help in the decision as to whether it meets the needs of the particular business:

1. Is the formation easy or difficult?
2. What is the feasibility of aggregating sufficient sums of money for the purpose of the business?
3. How is the risk shared, and what is the liability of the owners?
4. In whom shall rest the authority and responsibility of management?
5. What stability does this form offer?
6. Does it offer flexibility as to expansion, management, and movement?
7. What is the legal status of this form as applied to my business?
8. To what extent is it free from government control?

Facility of formation.—Some forms of business organization require no special effort to start, while others may involve difficult and expensive legal proceedings occupying considerable time. Some have to be most carefully contrived to be permitted to organize under the laws of the respective states. The small business organizer will do well, if possible, to avoid complicated forms and organize in as simple and easy a manner as his type of business will permit. Of course, the more difficult forms often possess features or advantages necessary to the welfare of his business, in which case the extra trouble and expense of organization are justified.

Feasibility of aggregating capital.—Many thousands of promising businesses have been wrecked because their organizers were unable to raise a few extra dollars of capital. An organizer must make a liberally adequate estimate of the amount of capital needed to make a success of his business enterprise, and he must choose a form of organization which will unquestionably make possible the raising of this amount. If he himself has sufficient personal wealth, he may start individually and independently; otherwise, he may associate with himself other individuals who are able and willing to put together sufficient funds for the purpose. If, however, he anticipates a big business, needing very large capital and probably increasing from time to time, he must almost invariably choose a form of organization in which ownership can be sold in small units to large numbers of investors.

Sharing of risk.—The risk of loss which one may assume through liability for the company's debts in case of failure is one of the most important considerations in entering into or investing in a business. It is largely upon the risk involved that an investor will base his opinion as to the amount of return he will demand on his investment. In some forms of business organization, the personal property of the owners may be claimed by the company's creditors, and, when this is possible, the expected return must be high to warrant the investment. Creditors are always the potential owners of a business; so the investor in any business must look beyond hoped for prosperity to possible insolvency and determine

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who, in that event, must share the loss and to what extent the creditors can come back upon him or upon his individual resources.

Before investing in a business in which he assumes considerable risk, the investor will do well to see that the form of organization is such as to give him considerable control. The greater the risk involved, the greater is the control desirable.

Authority in management.—In the various types of organization, authority is vested in different ways. In some lines of business the personal element of the owner is highly necessary; in others it is not. Where such owner personality is needed in the conduct of the business, it can be obtained by choosing a form like the individual proprietorship or partnership; those forms in which managerial authority is delegated, as in the corporation, absolutely eliminate this feature.

Stability of organization.—It is highly important to the investors and to all other persons with whom the business has to deal that the business have stability and also a certain degree of permanency; if its life is limited, it should be to some definitely known period. Some forms of organization, as we shall see later in this chapter, are subject to sudden and unexpected dissolution for many reasons beyond the control of the owners, while others have continuous and uninterrupted existence.

The flexibility of expansion, management, and movement.—It is desirable at the outset to provide a form of organization that will permit expected expansion of the business without complete reorganization at some future date. As the business grows, the problems of management will also increase, and there must be adequate provision for the necessary delegation of authority. In the case of some businesses, it is very important that the business be able to establish branches or agencies for doing business in several places in different states. For some forms this is easy; for others it is beset with restrictions, legal provisions, and expenses. It is well to make a study of this particular feature of each form of organization before selecting one.

Legal status.—Every form of business organization is

governed by laws of some kind and there are many restrictions as to what certain forms may do. Those which are formed under definite statutes must live up to the very letter of the law. The laws relating to partnership are pretty well crystallized in the uniform partnership law, but the laws of corporations differ widely in practically every state. Regardless of what one may know of business methods and operation, he will do well to employ the services of a good lawyer in establishing the legal status of his organization in the jurisdiction in which he expects to organize.

Governmental control.—Beyond legislating as to what shall constitute certain forms of organization, the various states, as well as the national government, exercise considerable control and regulative power over the conduct of business in general. Private enterprises enjoy far more freedom with regard to this governmental regulation than do those engaged in public service, but even certain forms of private businesses are subject to close governmental regulation and visitation. The corporation is more closely supervised than any other form, while the individual proprietorship and partnership are almost unmolested. This governmental regulation is intended to promote the economic welfare of all, but frequently it becomes irksome to the company itself. Very often if the organizers see beforehand that it will be too much of a burden, they will seek to find, if possible, some other form of organization upon which government supervision does not bear so heavily.

The individual proprietorship.—The simplest and oldest form of business organization is the *individual* or, as it is sometimes called, *sole proprietorship*. It is in a sense a one-man organization, for the owner and proprietor is solely responsible for all the activities and liabilities of the business. In small businesses where the capital investment is small, this form of organization is most practical. No formality need accompany its formation. Every man has a right to engage in any lawful business without special sanction or permission from the state. There are, to be true, special police regulations—such as the obtaining of licenses, building permits, and the like—which must be complied with in certain businesses and in some localities; but these

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regulations, which usually have in mind the protection of the public health and safety, are restrictions upon the business itself and not upon the right of an individual to engage in that business.

The individual proprietorship is popular today in spite of the concentration of so much of our economic activity in large business units. It is entirely flexible as to management: the owner may discontinue one form of activity and take on another at will, and he may engage in a dozen side lines totally unconnected with his main business, should he so desire. It is flexible as to movement: the Federal Constitution (Art. IV, Sec. 2) guarantees the right of an individual to carry on his business in any state with all the freedom of a citizen of that state. The fact that all profits are to go into the proprietor's own pocket is an incentive to industry and close application to the business.

The personal nature of the individual proprietorship has other advantages. The reputation of the owner for honesty and integrity is the reputation of the business itself. In some businesses, people like to deal directly with the proprietor. This is splendidly illustrated by the ability of some independent stores to withstand the competition of the large chain stores, even though the chain offers lower prices.

In some businesses it is important that trade secrets be maintained. The close contact of the sole proprietor with his employees and his close supervision of his business affairs help in keeping the affairs of the business secret from competitors. There are no stockholders to whom statements of income profit and loss must be submitted, and no submission of reports to governmental bureaus, where they become matters of public record, is necessary. There are no special taxes upon the individual proprietorship as an organization. There are no organization taxes to be paid, no matter how much capital is put into the organization at the beginning. The owner is, of course, as an individual, responsible for property and income taxes, but there are no Federal taxes upon the business as an organization.¹

¹ New York has an Unincorporated Business Tax which is in the nature of an income tax and applies to individual proprietorships, general and limited partnerships.

The individual proprietorship is, however, strictly limited in the amount of outside capital which can be brought into the business. While real estate and chattels owned may be mortgaged, the general credit of the business is limited to the personal resources of the proprietor and funds cannot be borrowed for long periods of time. This is due to the obvious lack of stability or continuity of the business as an organization. The business, as such, ends with the death, insanity, or bankruptcy of the owner. Even though the activities be carried on by a successor, it is now a different business and the personal credit of the new owner is the credit of the new organization. This inability to obtain large amounts of capital usually prevents the growth of the business to a large size. Expansion is largely dependent upon the reinvestment of earnings by the proprietor.

A further limitation upon the expansion of the business is the inability of one man to supervise the detailed operations of a large business. True, the owner may delegate his authority to employees, but it must be remembered that he alone is responsible for any debts of, or claims arising against, his business. Hence, for his own protection, he is compelled to maintain a careful watch over all its activities. As the business grows in size, it is necessary to delegate more and more authority to others and, as a result, it is difficult for him to keep close control.

Chief advantages of the individual proprietorship are:

1. Ease of formation.
2. Simplicity and flexibility of control and movement.
3. Presence of the personal element; a strong incentive to industry.
4. Secrecy.
5. Freedom from organization and franchise taxes.
6. Freedom from governmental control.

Its disadvantages are:

1. Difficulty in raising very large sums of capital for expansion.
2. Unlimited liability of the proprietor for all debts of the business.

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3. Lack of stability or permanence.

4. Limitations upon the extent to which its powers can be delegated, preventing great expansion.

The general partnership.—A *partnership* is an association of two or more persons to carry on as coöwners a business for profit (Uniform Partnership Act, Part II, Sec. 6). It is reasonable to assume that the development of the simple general partnership followed quite close upon the beginnings of business enterprise. The need for the help of another, either in skill or capital, led to the formation of a general partnership where the ownership and participation in the business are enjoyed not only by one but by more than one person.

Simple as this form of organization may seem, the relationship between members of a partnership and the dealings of such firms with one another have been subject to much litigation. The laws affecting the general partnership have developed through such litigation, and the practices followed by organizations of this type have grown through more than three centuries and have recently been codified in the Uniform Partnership Law, which was adopted in New York State October 1, 1919 (See N. Y. Laws 1919, Chap. 408). At the present writing, the Uniform Partnership Law has been adopted in whole or in part by eighteen states.

Contractual nature of the general partnership.—The partnership does not require a special charter or franchise from the state but is formed by a simple contract between two or more persons. Such contracts may be oral, if they can be performed within a year, or in writing. While the Uniform Partnership Law states that "persons who are not partners as to each other are not partners as to third persons," the absence of any written contract or evidence of an oral one does not necessarily mean that a partnership does not legally exist. The existence of the partnership relation may be implied in law from the acts of the persons involved. The law states that the "receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner" unless such profits are received as installments on a

debt, wages, rent, interest on a loan, or as a consideration for the sale of the goodwill of a business.

As a general rule, something more than mere sharing of profits is required as evidence of intent to form a partnership. The existence of a partnership will be implied in law where there is (1) a joint interest in a business (as distinguished from any other activity, for example, a philanthropy); (2) a common investment; (3) a sharing of the profits as such; (4) a control of the business on the part of each.

There is also a situation where, even though no actual partnership exists, a person may be held liable as a partner by third parties. In the words of the Uniform Partnership Act (Sec. 16), "when a person by words spoken or written or by conduct, represents himself, or consents to another representing him to anyone, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, extended credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner he is liable to such person, whether the representation has or has not been made or communicated to such person as giving credit by or with the knowledge of the apparent partner making the representation or consenting to its being made." This is called *partnership by estoppel* in legal terminology; it means that having led third parties to believe that he is a partner to their injury, the person making the representation may not later deny liability on the ground that he is not a partner.

Legal status of the partnership.—It has been noted that the formation of a partnership does not rest upon any special grant of authority from the state, but upon the common-law right of one individual to contract with another. The partnership firm is not an entity: partners may not sue the firm, but of course may sue one another as a remedy for breach of the partnership contract.

Real estate owned by the partnership may be held in the firm name, in the names of all the partners, or in the name of

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one partner, who in such case holds it in trust for the firm. The equitable interest in real estate held in the firm name may be conveyed by a deed signed by one of the partners in his own name, if such an act is done in carrying on the business of the partnership (See Uniform Partnership Act, Sec. 10; or N. Y. Laws 1919, Chap. 408, Sec. 21, for full details with regard to the conveyance of partnership realty).

A suit brought against a partnership must be brought in the names of all of the partners and not in the firm name.

Taxation of general partnership.—The partnership does not have to pay an organization or franchise tax. It is liable for property taxes upon property held in the firm name. Partnerships as such do not pay federal income tax, but the partners are individually liable for the taxes on the distributive shares of the profits for the taxable year or upon the profits during the accounting period ending within the taxable year. Nevertheless, the partnership is required to file a return showing its gross income and allowable deductions, the names and addresses of the partners entitled to a distributive share of the net income, and the amount of each share.²

Authority of each partner.—Each partner is an agent for the partnership for the purpose of its business and may bind the partnership firm by any act which is apparently for the carrying on in the usual way of the business of the partnership. This does not prevent agreement among the partners themselves which may limit the authority of any one of the partners. Such limitations, however, are not binding upon outside parties in dealings with a partner unless the party has knowledge of such a limitation. Should the act be one not apparently within the scope of the partnership business, the firm is not bound by the partner's acts; and, unless the business has been abandoned by the other partners, no partner without the consent of the other partners has the authority to:

1. Assign partnership property in trust for creditors.
2. Dispose of the goodwill of the business.
3. Sell at one time all the partnership property.

² See footnote No. 1 page

4. Do any act which would prevent the carrying on of the usual business of the partnership.
5. Confess a judgment.
6. Submit a partnership claim to arbitration.

The filing of general partnership agreements in some office of public records is not sufficient notice to outsiders of the terms of the agreement. There is no statutory requirement that such agreements be filed; hence, there is no obligation on the part of anyone to look for them. Common prudence ought to dictate that when a partner attempts to do something in the firm name which is unusual, the person dealing with him should question his authority.

As between the partners, any breach of the partnership agreement limiting the powers of a partner may be treated by the other partners as an act of bad faith which might justify proceeding in a court of equity for an accounting and dissolution or as a breach of contract, giving rise to damages which could be sued for at law.

Liabilities of the partners.—The liability of the members of the partnership is joint, but in effect the partners are jointly and severally liable for the debts of the firm. This means that the liability of each partner is unlimited. A creditor of the firm, having obtained a judgment against it which cannot be satisfied because of the lack of partnership assets, may execute the judgment against the personal assets of all the partners or against the personal assets of any one of them. In a bankruptcy or dissolution proceeding, the assets of the partnership firm are first used to pay creditors; then, if there is still an amount owing, it is settled out of the partners' personal estates. As long as each partner has sufficient personal assets to take care of his own share, effect will be given by the court to any partnership agreement as to the method of sharing losses; but should the personal assets of one fail to be sufficient for his rightful share, the other partner's personal assets may be called upon to make up the deficiency. However, in a bankruptcy or dissolution proceeding, personal creditors of the partners will be paid out of the personal assets before the firm creditors may exercise

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their claim against such assets. The rule may be simply stated thus: In a bankruptcy proceeding, firm creditors have the first claim against firm assets, and personal creditors have the first claim against the individual partner's personal assets.

In any case where a partner is called upon to pay more than his share of loss, he will be given a right of contribution against the other partners, and he can compel them to contribute their just share.

It should be emphasized that in the absence of agreement and without regard to the capital contribution of the various partners, profits and losses are shared equally. A partner who makes no capital contribution at all, perhaps giving only his name or services, will receive, unless otherwise agreed, a share of the profits, or he must bear a share of the losses, in as great a proportion as a partner who has contributed the larger part of the capital.

Dissolution of a partnership.—A general partnership may be dissolved in any one of the following ways:

1. Contract.
 - a. Lapse of agreed period.
 - b. By mutual agreement to dissolve.
2. Bankruptcy of a partner.
3. Bankruptcy of the partnership.
4. Withdrawal of a partner where no fixed term has been agreed upon.
5. Death of a partner.
6. War between nations of which partners are citizens.
7. Court decree in cases of:
 - a. Misconduct which prejudicially affects the carrying on of the business.
 - b. Insanity.
 - c. Breach of the partnership agreement.
 - d. Partners' inability to carry on the business except at a loss.
 - e. Court's finding dissolution necessary and equitable.

The withdrawal of a partner and the conveyance of his interest in the partnership does not of itself dissolve the partnership where the partnership is for a definite term. All

that the purchaser obtains is a right to the share of the profits distributable according to the partnership agreement.³

In the dissolution of a partnership, the order of the payment of claims against the partnership assets is as follows:

1. Those owing to creditors other than partners.
2. Those owing to partners other than for capital and profits.
3. Those owing to partners in respect of capital.
4. Those owing to partners in respect of profit.

Delectus personarum.—The contract of partnership is a personal one, and the right to participate in the control and management of it cannot be assigned by one partner without the consent of all. Upon the conveyance by one partner of his partnership interest, the only right received by the purchaser or assignee is the right to profits discussed in the preceding paragraph. He may not interfere in the administration of the partnership business affairs during the continuance of the partnership, nor may he inspect the partnership books. Should he believe himself unfairly treated, he must have recourse to a court of equity where he may ask that a receiver be appointed and an accounting made. It is, of course, up to the court in the light of all the facts, to decide whether such a course would be equitable. Even should a partner die and the remaining partners decide to continue the business, the heir of the deceased partner may not of right demand admittance to the partnership.

General characteristics of the partnership.—The partnership form of organization offers better opportunity for aggregating capital than does the individual proprietorship, for additional capital can be obtained through the contributions of members of the firm. Then, too, there is the additional credit gained through the combined personal credit of the

³ Where dissolution is caused in contravention of the partnership agreement, the other partners are entitled to damages and may continue the business in the same name by putting up a bond to secure payment of the withdrawing partner's interest, or may pay him the value of his interest less damages and goodwill. The retiring partner must be indemnified against future partnership liabilities. [See Uniform Partnership Act, Section 38, par. (2)]

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several partners. From the point of view of the creditor, the unlimited liability of the partners lends an element of strength to this form of organization. However, this same feature deters many from investing as partners in the enterprise.

Against the possibility of aggregating greater sums of capital through the admission of new partners, there is the unwieldiness of an organization consisting of many members. The constant likelihood of dissension and disagreement among a great number of persons where each has the same authority in the management of the concern is a decided detriment to the obtaining of large sums of money in this manner.

The lack of stability due to the ease of dissolution of a partnership prevents borrowing for long terms on the general credit of the business.

In businesses where it is desired to be free from statutory limitations and government control, the partnership has a decided advantage. This has led to the adoption of the partnership organization in preference to that of the corporation in the case of the New York Stock Exchange and other exchanges throughout the country. The partnership is free to engage in any business it wishes to, and there is no obligation to make reports to the state or disclose the partnership affairs to anyone. Since the partnership, as such, is not distinct from the individuals who compose it, there are no restrictions upon its conducting its business freely in any state of the Union without the express permission of that state.

The partnership agreement.—There are so many questions that may arise after the formation of a partnership that an agreement should be drawn in writing at the outset. While no two agreements will be alike in all particulars, the following points ought to be covered¹:

1. *Nature of business.*—The scope of the business and the relation of each partner to the business should be clearly

¹ Montgomery, R. H., *Financial Handbook*, 1927 edition, pp. 716-718 (Ronald Press Co., New York, 1927).

stated; also, whether a partner is permitted to engage in outside transactions, and whether or not each partner is required to devote all of his time to the business.

2. *Capital*.—Specify the amount to be contributed by each partner, and how it is to be paid. If partners agree to contribute equally, the agreement should state whether cash or its equivalent is to be paid in and the penalty, if any, for the failure of one partner to contribute as much as another.

3. *Changes in capital*.—If undrawn profits automatically increase and losses decrease the capital accounts of the partners, the agreement should cover the point fully, since the interests of the partners in capital and profits may not be the same.

4. *Interest on capital*.—Unless provided for in the agreement, capital contributions do not bear interest. If interest is to be allowed, the rate should be fixed.

5. *Withdrawals*.—Since this is frequently a matter of dispute, explicit provision should be made to cover the manner and extent of withdrawals and the penalty for overdrafts.

6. *Undrawn profits*.—If profits are allowed to accumulate, the agreement should state whether such amounts are to be treated as loans or additional capital. This provision is important, since the agreement may provide (See below) that profits are to be apportioned on the basis of capital contributed.

7. *Interest on loans or withdrawals*.—If it is desired that interest should be allowed on loans, or charged on withdrawals, the agreement should be so stated and the rate specified.

8. *Distribution of profits or losses*.—The method of apportioning profits or losses should be stated and each partner's percentage specified, also any contingency which may affect the share of any one should be included.

9. *Approval of accounts*.—There should be some agreement as to the approval of the individual partner's accounts in respect to withdrawals as well as in respect to the income and capital accounts.

10. *Salaries of partners*.—If any partner is to receive a stated salary, the amount, also, should be specified, when it is to be credited, whether or not interest is to be allowed

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thereon if undrawn, and whether the amount is to be charged as an expense of the business before the profit or loss is ascertained.

11. *Dissolution*.—The procedure should be stated in regard to the death or withdrawal of a partner: whether the books shall be balanced at once or allowed to run on to the end of the month or other period; whether, in case of dissolution, the partners are to share losses in the same proportion as each one's capital bears to the entire capital.

12. *Special causes for dissolution*.—If the partnership can be dissolved for any reason other than death, such as disability or intemperance, complete details should be stated.

13. *Settlement after dissolution*.—It is important not only to arrange the method of determining each partner's share upon dissolution, but it is equally important to fix the details of payment. The most equitable way is to provide for full payment within a fixed period, or to pay a certain proportion annually or semi-annually. The rate of interest on balance should be stated.

14. *System of accounts*.—To obviate subsequent differences of opinion as to the system of accounts, the agreement should specify the type of accounts to be kept, that they be balanced regularly and that they be audited annually or oftener by a professional accountant. It is desirable that the method of selecting the auditor be stated.

15. *Disputes about accounts*.—An arbitration clause should be inserted to the effect that if any dispute arises involving the accounts, it is to be submitted for settlement to a certified public accountant to be mutually agreed upon. Since disputes occur with respect to other matters as well as to the accounts, in such cases the reference should be made to a certified public accountant and a lawyer, with power lodged in them to select a third party in case of disagreement.

16. *Firm insurance*.—If life insurance for the benefit of the firm is to be carried on the life of one or more partners, there should be stated how the premiums are to be paid and the disposition of the proceeds if collected. Also, it is well to state the disposition in case the partnership is dissolved while the policy is in force.

17. *Goodwill*.—If withdrawing partners or representatives

of deceased partners are entitled to goodwill, based on profits or otherwise, the method of calculation should be stated in detail. For instance, if salaries of partners are treated as business expenses in determining annual distributions, it must be stated whether or not such salaries are to be likewise treated if goodwill is based on *average net profits*. Salaries of partners and interest on partners' capital are in reality divisions of profit—not expenses—and it requires a clear and affirmative agreement to deal with them as expenses. Where no agreement exists as to how the profits are to be divided, the law gives each partner an equal share in the profits and assumes that the losses will be borne equally by each partner.

The advantages of a partnership are as follows:

1. It is easy and inexpensive to organize.
2. The unlimited liability of partners makes it reliable.
3. The direct gain to its members is an incentive to close attention to business.
4. The personal element in the characters of the partners is retained.
5. It is generally free from governmental control.
6. It is free from organization taxes.

The disadvantages of a partnership are:

1. It has the danger and lack of stability that come from liability of dissolution.
2. It has divided authority.
3. It has instability, due to the need for constantly harmonious action.
4. Personal liability for firm debts deters many from investing capital in it.
5. Its borrowing power is usually limited.

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Questions for Study and Review

1. State eight factors which should be considered in choosing a suitable form of business organization.
2. What are the advantages and disadvantages of the individual proprietorship as a form of business organization?
3. What conditions must be present if a general partnership is to be implied in law?

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4. What is the authority of a general partner in the conduct of the firm's business?

5. State six limitations upon the authority of general partners to act for the firm.

6. To what extent are partners liable for the firm's debts?

7. State seven ways in which a general partnership may be dissolved.

8. What is meant by *delectus personarum* in connection with a partnership contract?

9. State at least ten points that ought to be covered in a partnership form of agreement.

10. Summarize the advantages and disadvantages of a partnership form of organization.

Problems

1. A partnership with ten partners finds it desirable to attempt to curtail the general agency powers of the various partners, to assign certain duties and powers to each one, and to limit the power and authority of each one to the duties assigned him. How and to what extent can this be done?

2. Mr. Adams and Mr. Bryan were partners in a retail business. Mr. Bryan sold out his interest in the partnership to Mr. Williams. Explain in detail the situation which this brings about, showing the rights of all parties.

3. Mr. Baldwin and Mr. Hendricks organized a partnership with a written agreement that they were to remain in business as partners for ten years. Mr. Baldwin withdrew at the end of five years. What situation does this bring about, and what, if anything, can Mr. Hendricks do?

4. Anderson, Bagley & Caldwell is the firm name of a partnership having three partners with the names mentioned. At the start Mr. Anderson invested in the business \$60,000 in cash; Mr. Bagley, \$30,000 in cash and property worth \$10,000; Mr. Caldwell invested property worth \$20,000. There is nothing in the contract of partnership as to the method of dividing profits. The business started out very well, and during the seventh month Mr. Anderson needed some cash and drew from the company \$10,000 as an advance against expected profit; in the eighth month Mr. Bagley similarly took out \$6,000; and in the

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tenth month Mr. Caldwell in like manner took out \$5,000. Now, at the end of the first year, the firm has, after allowing for cash already drawn by the partners, the sum of \$9,000 as profits to be divided. What will each partner be entitled to out of this sum?

5. Suppose that the partnership agreement in the above problem provided that the three partners should participate in the profits in proportion to their respective investments in the business. What would then be the amount due to each partner at the end of the year?

6. Messrs. Archer, Barclay, and Carpenter engage in business as the Acme Shoe Company, a partnership. The company starts out with a capital of \$360,000, the partners investing, respectively, \$180,000, \$110,000, and \$70,000. During the third month it is found that the business needs additional funds to meet unforeseen expenses, and Mr. Barclay lends the firm \$60,000. Before the end of the year, the partners see that they cannot make a success of the business and the firm is dissolved. At dissolution, it owes outside creditors \$190,000, and the proceeds from the sale of all of its assets amount to \$400,000. How shall these proceeds be divided among all interested parties?

7. The partnership of Anderson, Buckman & Cole was started with a capital of \$200,000, which was contributed in equal shares by the three partners. The business has not been prosperous, and the partners believe it would be better to dissolve and take their present losses than to try to continue the business and thereby probably increase their losses. You are called in as an impartial business adviser. In their statement to you, they say that their business will bring at forced sale the full value of capital invested; namely, \$200,000, but that they owe the firm's creditors the sum of \$290,000. Outside of the business, the three men own in cash and salable property, free of all exemptions, respectively, \$80,000, \$60,000, and \$40,000; but Mr. Anderson has personal debts of \$30,000, Mr. Buckman, of \$20,000, and Mr. Cole, of \$12,000. Give them your estimate as to just how their finances will stand if they dissolve at once and have a receiver appointed.

CHAPTER IV

Choosing the Form of Business Organization (*Continued*)

Limited Partnership, Joint Venture, Joint-Stock Company, Massachusetts Trust

The limited partnership.—The *limited partnership* is a form of business organization having any number of general partners who manage the business and have all of the rights and liabilities set forth in the preceding chapter, and having also one or more limited or special partners with rights and liabilities quite different from those of the general partners. A limited partnership cannot be formed by an ordinary agreement but only by one drawn in accordance with strict statutory requirements.

The chief characteristics of limited or special partners which differentiate them from the general partners are as follows:

1. Their liability for the firm debts is limited to the amount invested or agreed upon by them to be invested in the business.
2. Their withdrawal from the organization is prohibited.
3. They have absolutely no voice in the management or control of the business.
4. They must be bona fide part owners of the business and not merely lenders of money; as such they are entitled to share in the profits of the business but not to receive interest.

If the names of the limited partners are used or displayed in any manner in connection with the business, it must be made plain and clear, beyond reasonable possibility of misconception, that these members are connected with the firm

in a limited capacity; otherwise, they will be liable as general partners for the satisfaction of the debts of the firm. The business may be adjudged a general partnership and all the members general partners if the limited partners overstep their legal restrictions in any manner, or if the stipulations of the state statutes are departed from in the slightest degree.

Although the limited partner who interferes in the management of the partnership in any way may be held liable as a general partner, it must not be inferred that he may not be employed by the partnership or transact partnership business. However, any participation which he may take in the partnership must be clearly subject to the direction and control of a general partner. Further, a limited partner may lend money to the partnership and may lend his name as security for the partnership on the partnership's negotiable paper as long as the statutes as to non-interference in the management of the concern are complied with.

A limited partnership formed in one state has no legal standing as such in any other state; it has simply that of a general partnership. The only way to give limited partners full protection is to organize the business as a limited partnership within, and under the laws of, each separate state in which the firm is to do business.

This form often enables owners to obtain capital investment from men of wealth who would not consider entering a general partnership with the unlimited personal liabilities for firm debts which are attached to it.

In case of suit the firm sues and is sued in the names of the general partners.

The joint venture.—A temporary association of individuals or firms for the purpose of carrying through some particular business transaction or deal (this association ceases upon the successful termination of, or upon the failure of, its purpose) is known as a *joint venture*, or sometimes as a *joint adventure*. It is formed by a simple contract agreement as is the general partnership; and, as in the partnership, each participant assumes unlimited liability for the debts of the concern. This form lacks stability because of the danger of dissolution, but not to such a great extent as does the general partnership. With the following exceptions a joint venture

may be dissolved through the same contingencies as the partnership:

1. A member cannot withdraw without the consent of all the other members; but if he does withdraw with such consent, his withdrawal does not dissolve the organization.

2. The bankruptcy of a member does not necessarily dissolve the organization, though it may do so. Such action depends upon the nature of the venture and the duties and importance of the bankrupt member.

3. Its continuance is not affected by the death of a member; his personal representative may take his place.

4. War between nations represented in the nationalities of the members would not dissolve the concern if it could be shown that intercourse with an alien enemy was not essential to the enterprise.

The title to the property of the organization is usually vested in one member known as the *manager*. Unlike his power in the partnership, a member in the joint venture cannot bind the other members of the association by his acts, although the manager is, by the contract agreement, usually given practically unlimited powers to act for the other members.

One of the principal differences between the joint venture and the partnership is that in the former one member may sue the other members at law for his share of the profits. This is not permitted in the partnership. Suits are brought and sustained in the names of the members; but if one member has conducted the business in his own name, he may sue and be sued in his name.

More details of this form of organization will be studied when the subject of security underwriting syndicates is taken up, as such syndicates constitute a special form of the joint venture.

The joint-stock company.—This form of business organization may be defined as a voluntary association of individuals, without a charter from the state, but having capital divided into transferable shares, the ownership of one or more of which is a condition of membership.

Joint-stock companies are much more numerous in Eng-

land than in the United States; their place here is largely occupied by the corporation. They originated in England about 1660, at the time when large companies engaged as trading associations, such as the East India Company, the South Sea Company, and others, were operating under a very loose type of organization. They were made up of many agents, each of whom was entitled to a share of the profits in varying proportions. It was very difficult to determine just what share of the profits each agent was to receive, and there was always difficulty in making a satisfactory accounting upon the death or withdrawal of one of the agents. Difficulty was also encountered in formulating a general policy for the conduct and management of the association, owing to the fact that there was no governing body which could act with complete authority for the whole organization. A plan was eventually worked out whereby the assets of the association could be appraised and transferable shares of ownership, represented by certificates, issued to each member in proportion to his investment. These certificates were evidence that the holder owned a certain part of the assets of the company and was, therefore, entitled to his proportionate part of the profits. In order to make for a practical centralized control, each shareholder was given a vote in choosing a board of managers or directors who had authority to act for all of the members.

Formation of the joint-stock company.—A contract or certificate of agreement among the parties to the organization, setting forth the necessary relations between them and the company, is all that is necessary to organize a joint-stock company. The formation is as free from statutory limitations and requirements as is that of the general partnership, and in most states no filing or recording of the contract or certificate is required. New York State, however, does require that there be filed with the Secretary of State and with the clerk of the county in which the organization is formed, a certificate setting forth its name, place of business, date of organization, number of original shareholders, and names and addresses of the officers. Persons who later purchase shares of the company thereby become parties to the contract of organization and members of the company.

✓ **Feasibility of raising large capital.**—Inasmuch as the ownership of the joint stock is divisible into a large number of shares, it can be offered for sale in a wide market, with the consequent possibility of finding many investors whose aggregate contributions will build up a large capital. This form also has (as will be shown later) considerable stability through its *continuous life*, and is, therefore, able to borrow funds for long terms; this privilege greatly adds to its capacity for raising large capital.

Liability of members.—In so far as liability is concerned the joint-stock company can practically be rated as a type of partnership. Since there are no statutes relieving any members from liability, as there are in the case of the limited partnership, every member or shareholder has unlimited joint and several liability for all the debts of the firm contracted during the time he is or was a shareholder.

Many stock companies seek to exempt their members from this liability and to limit their risk to the amount of their investment, as is the case generally in the corporation (See Chapter V), by placing in the articles of agreement a clause providing that the board of managers shall not be empowered to bind shareholders personally and that in every contract of the company the board of managers shall make reference to this agreement, thus warning the other party to the contract that neither managers nor shareholders shall be liable for any debt incurred through the contract, but that the creditor can look only to the funds and property of the company for his payment.¹ Such a claim of immunity, however, does not affect an outside party in any way and adds no protection whatever to the members unless the provision is brought to the actual notice of the outside party in question. If it can be shown that the outside party did have the proper knowledge of the agreement, he will, in most jurisdictions, be considered as having become a party to it through his contract with the association, thus giving the shareholders the protection desired. In some jurisdictions, however, notably the State of New York, there are conflicting rulings, and the exact amount of protection

¹ See articles of Pierce Fordyce Oil Association in C. W. Gerstenberg's *Materials of Corporation Finance*, p. 6.

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afforded by such a clause in the joint-stock company agreement is uncertain, often depending upon many contingent circumstances involved in the special case in question.

✓ **Authority in stock company management.**—The ownership in a joint-stock company is usually divided among a very large number of shareholders, making it impracticable for all to take a direct hand in the management. The articles of agreement, therefore, customarily provide for the election, by the votes of the shareholders, of a board of managers or directors. This board of managers has entire charge of the management of the business and appoints the necessary officers, such as president, vice-president, secretary, treasurer, and others, to conduct the operation. The distribution of profits in the form of dividends on the shares is within the province of the board of managers. By-laws adopted by the shareholders provide for the management of internal details and routine of the company.

✓ **The joint-stock company has stability.**—The joint-stock company enjoys greater stability than any of the other forms of organization thus far discussed. Its duration is unaffected by the transfer of shares of ownership, by the bankruptcy of a member, by the death of a member, or by war. There is no *delectus personae*, and a person buying shares from a retiring member, or inheriting them from a deceased member, assumes immediately the full rights and privileges of his predecessor. Thus, while the personnel of the membership may be constantly changing, the organization, as such, has continuous life. It must be noted, however, that *continuous* does not mean *perpetual*.

These organizations may be ended by:

1. Lapse of the agreed period under the articles of association.
2. Insolvency proceedings (the organization may be adjudged bankrupt and so may be discharged).
3. Decree of court, if a good reason may be shown.
4. Ownership of all the shares by the same person.

When these few logical and reasonable causes of dissolution are compared with the many unavoidable and unforeseeable ones affecting the partnership, it is easy to make a

choice between the two forms if stability is the principal feature desired.

✓ **Flexibility.**—The joint-stock company, having a board of managers authorized to conduct the business and to appoint or employ a full staff of officers and operators, is susceptible of great flexibility in both expansion and management.

As to movement, going into various states to do business, the joint-stock company is generally given the status of the general partnership, resting upon the constitutional rights of its individual members (U. S. Constitution, Art. IV, Sec. 2), and may do business in any state, except under such restrictions as may be imposed by the state upon its own joint-stock companies, without going through any legal process. (In New York, *e.g.*, an outside stock company must file the same certificate of information as is required of a stock company formed within the state.)

✓ **Legal status.**—Legally, the members of the joint-stock company are not agents for the firm. As in the case of partners, they cannot sue the company but must go into equity for an accounting. Under the statutes of most states the joint-stock company sues or is sued under the firm name, just as though it were a single entity (like a corporation); in the absence of statutory provision, however, the names of the members must be used, as they are in the partnership. The law of New York provides that if the stock company contains more than six members it can be sued in the name of the president or treasurer.

✓ **Government control.**—The joint-stock company is generally free from government control. The Federal Government taxes it very much as it does a corporation, and the State of New York requires an annual franchise tax. These governmental requirements are, however, so small in comparison with those applied to corporations as to be relatively negligible.

✓ **Advantages and disadvantages.**—The advantages of the joint-stock company form of organization are many and in point of number, at least, overbalance the disadvantages. If an absolute limitation of liability of the members could be brought about, this form would be preferred to that of

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the corporation by a great number of concerns now using the latter form. The most important points of comparison may be tabulated as follows:

Advantages of the joint-stock company:

1. It is easy and inexpensive to organize.
2. It makes possible the raising of a fairly large amount of capital by the sale of stock and by borrowing on long-term credit.
3. The unlimited liability of members (when it is not avoided) adds financial strength to the company.
4. The centralization of control in a board of managers avoids danger of lack of harmony among the agents.
5. The organization possesses considerable stability; it has continuous life.
6. It has flexibility as to expansion, management, and movement.
7. It is not legally complicated.
8. It is practically free from government control.

Disadvantages of the joint-stock company:

1. The unlimited liability of the members cannot universally be avoided; hence, the uncertainty deters some prospective investors.
2. The valuable personal element of the individual proprietorship, present also to some extent in the partnership, is lacking.

Limited partnership association.—This peculiar hybrid between the partnership and the corporation is provided for by the statutes of only four states, Pennsylvania, Michigan, New Jersey, and Ohio. As it is of practically no use outside of its state of origin, it will not be encountered often in general business. It is created, like a corporation, by filing a certificate of association with the state, and by paying an organization tax and is usually responsible for other state taxes on the same basis as a corporation. Its ownership is divided into shares, represented by stock, and the stockholders elect directors to manage the business. It differs from the joint-stock company and the corporation in this way: Upon the

transfer of any of its shares by an owner, the purchaser must be elected to membership in the association before he has any rights. He may demand election to membership, and if this is not granted, he may compel the association to pay him the value of his shares as agreed upon or as determined by appraisers appointed by the court. The transfer of shares does not, however, affect the life of the association. The laws of both Pennsylvania and Michigan governing these associations provide that every contract involving more than \$500 must be signed by two of the directors; and unless it is so signed, the association is exempt from liability on it.

In the state of its organization the members of a limited partnership association are not personally liable for the association's debts. The members will, however, be held liable unless the organization strictly complies with all the terms of the statute authorizing the organization. Outside the state of their organization, courts are inclined to treat these associations as general partnerships. This form of organization, therefore, is suited only to a business conducted entirely within the state of its organization. Except for the smaller initial expense of organizing, it has little, if any, advantage over the corporation.

The Massachusetts Trust.—*Massachusetts Trust* is the name given to the comparatively recently devised form of business organization which operates by placing the title to its property and the obligation to operate and manage the same in the hands of a board of trustees, thus creating what is legally known as a *trust*. It does not necessarily have any relation to the State of Massachusetts, but has been given this name because Massachusetts is the state where the idea of adapting the trust to active business purposes was first widely developed and used. Until the year 1912, Massachusetts had a law which forbade the organization of corporations to own and deal in real estate. This did not leave available a desirable form of business organization for raising and handling the large amount of capital necessary for large real estate and building transactions. The use of the trust was suggested and tried; and since it was found practicable and successful, its use spread very rapidly. It turned

out to be even more desirable in some respects than the corporation, and was soon used for many types of business enterprises other than those in the real estate field.

Besides the most commonly used name *Massachusetts Trust*, the same form of organization is known in different places by the names: *Business Trust*, *Common Law Trust*, *Business Association Formed Under a Deed of Trust*, and others.

Since the Massachusetts Trust is based entirely upon the legal principles of the trust, it will be well to look into these principles briefly before studying its application to business ownership and operation.

Trusts.—First of all, it must be clearly understood that in speaking of *trusts* in connection with business, we do not mean the monopolies or combinations of big business brought about by *voting trusts*, which were so prevalent some years ago and which were given the name *trusts*—a word which has developed an undesirable significance.

By the term *trust*, in its financial and business sense, we mean the holding and care of the property of one party by a second party, for the benefit of a third party, although the first and third parties may be the same, as in the case of a person who places his property in the hands of a trustee for his own benefit at a later period.

The principal parties to the formation of a trust are (1) the *trustor* (also known as the *grantor* or *donor*), who is the party placing his property in trust and thus actually creating the trust; (2) the *trustee* (either a person or a corporation), who receives, takes legal title to, and is charged with the management and preservation of the property which constitutes the trust estate; and (3) the *beneficiary*, for whose benefit the fund is established and who holds equitable title to the property.

When a person by means of a deed of trust places property, including the legal title thereto, in the hands of a trustee to be held by him for a specified time, and then to be delivered by the trustee to some certain beneficiary, who may be the trustor himself, he creates a *living trust*. If the party, however, provides in a will that upon his death certain of his property shall be held in trust by a trustee for

a beneficiary during a stated period, he creates a *testamentary trust*. It is often arranged that the income from the trust fund shall go to a certain person during the life of the trust, and at the expiration of the trust period the principal shall go to a different person. In this case, the person receiving the income during the duration of the trust is known as the *life tenant* and the person taking the principal at the expiration of the trust is known as the *remainderman*.

Living trusts are ordinarily irrevocable, unless the trustor expressly reserves the right to modify or revoke, and testamentary trusts cannot be changed after the death of the testator.

Trusts cannot be made perpetual, and the time limit varies somewhat in different jurisdictions. In most states, however, the limit is "two lives in being plus twenty-one years and nine months," which means that the trust can exist for twenty-one years and nine months after the death of the two persons named in the trust at the time of its creation.

The trust applied to business.—In organizing a business as a Massachusetts Trust, or a business trust, therefore, the organizers draw up a deed or declaration of trust which names a board of trustees; places in its hands the absolute legal title to all the property of the proposed business; specifies the terms and conditions under which the trust is to be managed and the business conducted; and makes themselves, together with others who may later become shareholders, the beneficiaries, who are to receive both the income during the trust and the trust property at the expiration.

The essential provisions in the organization of a business trust are:

1. The deed or declaration of trust drawn up to define the rights and powers of the trustees and holders of trust certificates.

2. Two or more trustees who are to hold in trust and manage the capital or property supplied by the shareholders.

3. Shareholders or certificate holders, who are the beneficiaries as well as the donors of the trust, and who will

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receive transferable certificates representing their respective interests in the profits and in the property on dissolution.

4. Provisions for the division of profits, the appointment of trustees to fill vacancies, meetings of shareholders, and dissolution at the termination of the trust.

5. Provisions that no liability is to attach to either trustees or shareholders, but only to the trust estate, and directions that such a statement be included in all contracts made by the trustees.

The board of trustees then proceeds to select officers for the company and otherwise to conduct the business just about as a board of directors would do in a corporation.

The ownership of the business is divided into shares, and the participants receive certificates (similar to certificates of stock of a corporation), called by some *certificates of stock* and by others *certificates of beneficial interest*. Among these shares, the board of trustees distributes the profits of the business as dividends.

Now, when a board of trustees is appointed at the beginning of a trust, that board is permanent during the life of the trust and cannot be changed either by the trustor or the beneficiary. If a trustee dies, resigns, or is removed for mismanagement or other good cause, a new trustee may be elected by the remaining trustees or by the stockholders, depending upon the provisions of the deed of trust. Beyond this, however, the personnel of the board is in no way under the control of the membership, and there are no periodical elections as in the joint-stock company and the corporation.

In business trusts organized in this manner, the stockholders are not personally liable for the debts of the organization, and creditors can look only to the trustees or, more usually, only to the property of the business for satisfaction.

Trust control by stockholders.—The characteristic of a trust which places the members of the board of directors permanently in their respective positions, so that they cannot be ousted or changed periodically at the whim of the stockholders, is a very good feature in cases where it is desirable to have the management remain constantly in the same hands; but many investors have been found to be

unwilling to place their money in the stock of a business in which they have no control whatsoever and no voice in saying who shall run the business as long as it exists after the board of trustees is once chosen. This unwillingness has led to the organization of some Massachusetts Trusts, or business trusts, which are true to form in other respects, but in which the deed of trust provides that the stockholders may by their vote elect trustees each year or at other stated periods, just as is done in the joint-stock company or in the corporation. Although such an organization is still generally *called* a trust, nevertheless this departure from one of the principal characteristics of the trust (the continuance of the same trustees) renders it absolutely *not a true trust*. The most important result is that the members or stockholders are no longer free from liability for the firm's debts, but are treated in this respect as partners having full personal liability.

Limitation of stockholder's liability.—This gaining of control through the right to elect trustees at the cost of giving up freedom from liability and assuming full liability for the firm's debts is, however, quite distasteful to the investor; and means must be found, if possible, to limit this liability and at the same time to retain the right to elect trustees periodically. Such limitations and rights are generally effected by inserting in the deeds of trust of organizations of this type, which have control over the election of their trustees, a special clause setting forth the fact that the stockholders shall not have such personal liability. Specimens of these clauses in actual use are as follows:

FROM THE DECLARATION OF TRUST OF THE MASSACHUSETTS ELECTRIC COMPANIES

The Trustees shall have no power to bind the shareholder personally, and the subscribers and their assigns and all persons or corporations extending credit to, contracting with, or having any claim against the Trustees shall look only to the funds and property of the Trust for payment under such contract or claim, or for the payment of any debt, damage, judgment, or decree, or for any money that may otherwise become due or payable to them from the Trustees, so that neither the Trustees nor the shareholders, present or future, shall be personally liable therefor.

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In every written order, contract, or obligation which the Trustee shall give or enter into, it shall be the duty of the Trustees to stipulate that neither the Trustees nor the stockholders shall be held to any personal liability under or by reason of such order, contract, or obligation.

FROM THE DECLARATION OF TRUST OF THE BOSTON PERSONAL PROPERTY TRUST

Neither the trustees nor the cestuis que trustent (shareholders) shall ever be personally liable hereunder as partners or otherwise, but that for all debts the trustees shall be liable as such to the extent of the trust fund only. In all contracts or instruments creating liability, it shall be expressly stipulated by the trustees that the cestuis que trustent shall not be liable.

As long as these provisions are strictly observed, they serve their purpose and protect the shareholders from liability to all creditors who have been duly notified of the provisions and who have entered into contract or granted credit upon these terms; if, however, the trustees have failed to insert the provision in the contract or to call the attention of the other party to its existence, then the liability of the shareholders still exists. Thus we have a condition similar to that of the members of the joint-stock company described earlier in this chapter.

Other features of the business trust.—The business trust adapts itself to the raising of large amounts of capital in that it has its ownership divided into shares which can be widely marketed, just as corporation stock is sold. The stock of the trust is often divided into several classes similar to those of the corporation, whose divisions and classes will be discussed in Chapter VII. On account of the lack of understanding on the part of the general public as to just what the business trust is and just what liability is involved, it is often a little harder to sell the securities of these organizations than to sell those of the corporation, but this is rather an unimportant consideration. From the standpoint of stability the trust is ideal, for, in its true form, not only does it have continuous existence during its entire period but it continues under the same management throughout. Even where the shareholders elect the trustees, it is as stable as the corporation, although its term of life is usually not so long.

This form of organization gives excellent flexibility in connection with expansion, management, and movement. By the issuance of securities it can expand its activities and capital to as great an extent as the prospects of the business will warrant. The trustees can provide, through the choice and election of officers, for as efficient a management plan as is desired. In regard to freedom of movement, the business trust of one state can do business in any other state on the same terms and under the same conditions as those governing trusts organized within that state.

Trusts are practically free from government control of any kind; this fact forms one of their most attractive features. They are generally free from organization taxes, though in New York they pay an annual franchise tax (just as do the corporations), and in Massachusetts they have to file their deeds of trust in each town and city in which they do business and in addition pay a small filing fee. Many corporations have changed to the trust form of organization to avoid heavy taxation, and for the same reason many new businesses that would otherwise have organized as corporations have been started as trusts. This practical immunity from taxes, which existed during the first several years of the trust organizations owing to lack of statutes concerning them, is fast disappearing, and state after state has been adopting laws placing business trusts on its tax lists in various manners. This is causing the trusts to lose a large portion of their early popularity.

Advantages and disadvantages of the trust form.—The advantages and disadvantages of the trust form of business organization may be set forth briefly as follows:

Advantages:

1. Its formation is simple and inexpensive.
2. It admits of the aggregation of large capital.
3. It insures freedom from personal liability on the part of the stockholders unless they have a choice of trustees.
4. It insures stability during the period of its life.
5. It provides flexibility as to expansion, management, and movement.

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6. It has, practically, freedom from government control; and it had, originally, freedom from heavy taxation.

Disadvantages:

1. It has no control over the personnel of the trustees if it be a true trust.
2. It is limited in duration.
3. Its securities are often not so easily marketed as are those of the corporation.
4. There is the possibility of unlimited liability for shareholders if they have exercised any control over the election of trustees.
5. Credit is somewhat limited because of this uncertainty of liability and because of the time limitation on the life of a trust.

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Questions for Study and Review

1. Explain the organization of the limited partnership, and state the relationship of the special partners to the business and their liability for loss through debts of the firm.
2. What is a joint venture? How is it formed? Why is it more or less stable than the partnership? What are the liabilities of participants for debts of the firm?
3. Discuss the liabilities of stockholders in a joint-stock company, and tell how they seek to limit their liabilities. Is the provision for this purpose in their organization agreement necessarily binding upon outside creditors? If not, what needs to be done to make it so? If the responsible authorities of the firm do not act as required in this matter, can the shareholders look to anyone for satisfaction?
4. What are the advantages and the disadvantages of the joint-stock company form of organization? Explain each.
5. Describe in detail the Common Law Trust, giving attention to the usual parties, the types, the purposes, and the length of life.

66 Choosing Form of Organization (*Cont.*)

6. What is a Massachusetts Trust? By what other names is the same type of organization known?

7. Who holds the legal title to the property of a business organized as a Massachusetts Trust?

8. What liability for debts of the firm have shareholders of a Massachusetts Trust in its true form?

9. Do shareholders in a Massachusetts Trust ever have any voice in the periodical choice of trustees? If so, how is such control brought about? What liability does it impose upon the stockholders? Can this liability be avoided?

10. Name and explain the advantages and the disadvantages of the Massachusetts Trust as a form of business organization.

Problems

1. The Empire Tailoring Company is a limited partnership organized under the statutes of the State of New York. Mr. Ayers and Mr. Boyd, both of New York City, are the general partners, and Mr. Crump, of Newark, N. J., is a special or limited partner. The business apparently prospers, and a branch is opened in Newark, N. J. Later, however, the company fails. How would the National Silk Manufacturing Company, of Paterson, N. J., a creditor who has supplied goods to the Newark branch, proceed to collect its claim, and against whom would it have any redress?

2. Mr. Austin and Mr. Barrett are partners in a retail grocery business. They need additional capital and urge Mr. Campbell to invest \$10,000 and become a partner in the firm. Mr. Campbell declines, but agrees to let them have \$10,000 for the business under the following conditions: that they discontinue their meat business and agree not to change the location of the business nor to open any branches without his consent; that he be given $33\frac{1}{3}$ per cent of the net profits annually; and that he have the right to withdraw his money upon six months' notice. Should the company fail, can Mr. Campbell be held liable as a partner? Advise Mr. Campbell how he can help out his friends to the extent of \$10,000, receive one-third of the profits, and still incur no liability beyond the possible loss of his investment.

3. Several gentlemen have purchased 40 acres of land immediately adjoining a growing town. They wish to develop it and

sell it off as building lots at a considerable profit to themselves, but do not wish to form any permanent association, seeking merely the most convenient method of accomplishing this one deal. Advise them as to the form of organization to use, and give your reasons.

4. Mr. Wallace owns 20 shares of stock in a joint-stock company and sells them to Mr. Walker. What rights has Mr. Walker after the stock is transferred to him? How do Mr. Walker's rights differ from those of Mr. Williams in Problem 2 of Chapter III, and why?

5. Mr. Gray comes to you for business advice, saying that he has an opportunity to buy some shares in a prosperous Massachusetts Trust, but he hesitates to invest his money thus because he has heard that "trusts" are illegal and, also, that in case of failure his personal property may be taken to satisfy the creditors of the firm. He asks you whether or not trusts are legal and if they are, why the contrary impression is current. He also wants to know how he can determine just what his personal liability is. Give him the information and advice desired.

CHAPTER V

Corporate Organization

Wide use of the corporation.—The corporation is without doubt the most important as well as the most complicated form of business organization. Practically all of the remainder of this text will be devoted to the financial activities of businesses organized in this form.

While about 20 per cent of all the businesses of the United States are corporations, these represent about 80 per cent of all the capital invested and, hence, greatly outweigh in importance all the other forms of business organization.

The corporate form of organization is used for other purposes than business. It is used for social clubs, fraternities, churches, municipalities, educational and charitable institutions, and many others; but these are beyond the scope of *business finance* and will be only mentioned and classified in this text.

Attributes of the corporation.—The corporation is a very old form of organization whose roots are lost in antiquity. In its earliest days, however, it appears to have been used almost exclusively for organizations of a municipal and religious character; its wide use for business purposes dates from comparatively recent times. The main underlying idea is that of the *collective person*, which means that, regardless of the number of members, owners, or stockholders in a corporation, it is regarded by the law as a fictitious person entirely separate and distinct from all those who compose it. Thus the organization is endowed with continuous life during the period of its charter regardless of the deaths or misfortunes of its members, and regardless of any number of partial or entire changes, substitutions, or replacements among them. This continuous life or continuous succession, as it is called, makes the corporation the most stable of all

business forms, for if chartered in perpetuity it may conceivably go on forever—an impossibility for any other form. Legislative enactments in the various states have given the corporation many additional attributes, such as a very limited liability of the members, the complete transferability of ownership of stock, the right to have several classes of stock, the right to own and hold stock of other corporations, the right of members to delegate the management to directors, and so on. Each of these will be discussed in its proper place.

Since the number of stockholders is unlimited and the corporation has a legal right to borrow funds, it may be seen that the form is ideally suited for businesses desiring very large capital, for its fund-raising ability is limited only by the amount of money it can induce innumerable investors to place in it either through stock purchase or through loans.

The corporation defined.—There have been from time to time many legal and economic concepts of the corporation, but the idea most widely accepted today is that the corporation is legally regarded as a fictitious person. Upon this basis, an acceptable definition may be framed as follows:

A *corporation* is a voluntary association of persons, natural or legal, organized under and recognized by the law as a person, fictitious in character, having a corporate name and being entirely separate and distinct from the persons who compose it, for the accomplishment of some specified purpose or purposes. It has continuous succession during the period of life assigned by its charter, and the right to perform as a natural person all the functions expressed in its charter, or implied thereby, or incidental thereto.

This definition brings out the fact that a corporation is not an organization *formed by the state*, as many say, but it is one formed voluntarily by persons in accordance with the provisions of the state laws, and then duly *recognized* by the state as a corporation. The persons forming the corporation may be either natural persons or legal persons; that is, either individuals or several existing corporations forming a new one by means of consolidation. It also brings out that the *legal person* recognized by the state is fictitious in character and neither imaginary nor artificial as stated

in many older definitions. When the legal entity is brought into being through incorporation, no court today *imagines* that a person has been created; nor has it any idea that there is any *artificial* thing brought into existence in the shape of a person; but in all cases it recognizes that the corporate person is a *legal fiction*, a person which the courts *know* does not exist and yet which, for purposes of convenience, they *treat as if it did exist*.

Other definitions.—Definitions of corporations have been made by the thousands, and the decisions in many cases at law have hinged upon the definition held by the particular court hearing the case. A careful analysis and comparison of a few of the most famous views is very interesting and profitable.

Probably the most widely quoted definition ever given in this country is that pronounced by Chief Justice John Marshall in the Dartmouth College case as follows:

“A corporation is an artificial being, invisible, intangible, and existing only in the contemplation of the law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and if the expression may be allowed, individuality, properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men in succession with these qualities and capacities that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal thing.”

An old and famous English description is that given in 1863 by Lord Coke:

“A corporation aggregate of many is invisible, immortal, and rests only in intentment and consideration of the law. They cannot commit treason, nor be outlawed nor excommunicated, for they have no souls, neither can they appear in person, but by attorney. A corporation aggregate of many can't do fealty, for an invisible body can neither be in person nor swear; it is not subject to imbecilities or death of the natural body and divers other cases.”

Blackstone, in commenting on the continuous life of the corporation, gives us a number of very excellent and clear expressions on the subject:

“In order to facilitate business and to increase production of wealth, there have been created by acts of the public power, running back to remote antiquity, associations for business, religious, governmental, and charitable purposes known as corporations. These artificial persons are called bodies politic, bodies corporate, or corporations, of which there is a great variety, subsisting, for the advancement of rights and immunities, which if they were granted only to those individuals of which the body corporate is composed, would, upon their death be utterly lost and extinct. To show the advantages of these incorporations, let us consider the case of a college in either of our universities, founded for encouragement and support of religious learning. If this were a mere voluntary assembly, the individuals which compose it might indeed, read, pray, study and perform scholastic exercises together, so long as they could agree to do so, but they could neither frame, nor receive any laws or rules of their conduct; none, at least, which would have any binding force for want of a coercive power to create a sufficient obligation. Neither could they be capable of retaining any privileges or immunities; for, if such privileges be attacked, which of all this unconnected assembly has the right, or ability, to defend them? And, when they are dispersed by death or otherwise, how shall they transfer these advantages to another set of students, equally unconnected as themselves? So also, with regard to holding estates or other property, if land be granted for the purpose of religious learning to twenty individuals, not incorporated, there is no legal way of continuing the property to any other persons for the same purpose, but by endless conveyance from one to the other, as often as the hands are changed. But when they are consolidated and united into a corporation, they and their successors are then considered as one person in law; as one person, they have one will, which is collected from the sense of the majority of the individuals; this one may establish rules and orders for the regulation of the whole, which are a sort of municipal laws of this little republic; or rules and statutes may be prescribed to it at its creation, which are then in the place of natural laws; the privileges and immunities, the estate and possessions, of the corporation, when once vested in them, will forever be vested, without any new conveyance to new successions; for all the individual members that have existed from the foundation to the present time, or that shall hereafter exist, are but one person in the law, a person that never dies; in like manner as the River Thames is still the same river, though the parts which compose it are changing every instant.”

William A. Wood, in his *Modern Business Corporation*, defines the corporation quite carefully as follows:

“According to contemporary practices a corporation is an association

of natural persons, or of other legally constituted persons (other corporations) authorized by law to act as a unit, under a corporate name, for the accomplishment of certain definite and prescribed purposes. It is a 'person' constituted by law, separate and distinct from its stockholders, and, in a certain sense, is a citizen. Action at law may be maintained against it the same as against a natural person."

A mere reading of these definitions shows that the entire underlying idea is that of the *collective person* created under the law through the union of its members, bound together by the corporate charter.

Formation of a corporation.—For long ages the granting of a charter of special rights or monopolies to a group of persons as a corporation was a crown prerogative in the European monarchies, though later on the parliaments took over the greater share of this power. When the American colonies were under English rule, charters in this country were granted by the King of England, by the British Parliament, by the royal colonial governors, by the proprietary colonial governors, and by the colonial legislatures. This overlapping and often conflicting authority would doubtlessly have led to much confusion and trouble had not the colonies gained their independence and the new colonial governments declared that all corporations in existence, regardless of their source, would be recognized as legal. Thereafter incorporating power was vested in Congress and in the various state legislatures.

Procedure in forming corporations.—For many years after the establishment of the Republic, the incorporation of a company in any state required a special act of the legislature. This often resulted in logrolling, political unfairness, and other abuses. Furthermore, the number of incorporations was increasing so rapidly that it was fast becoming a physical impossibility to pass a special bill for each company. Therefore, one after another, the various states passed enabling acts. Such acts usually took the form of a *General Corporation Law*, under which groups of qualified persons could form a corporation by making and filing a *certificate of incorporation* in proper form and paying the required fees. Practically all corporations are now formed in this manner, although it is still possible to organize under

a special act when, in the judgment of the legislature, the objects cannot be obtained under the general law.

Classes of corporations.—The corporation laws of the several states differ from one another in greater or lesser degree, and every student of corporations should gain familiarity with the details of his own state laws. In the following discussion the laws of the State of New York will be used, for, basically, they are fairly representative of those of many other states. Under these laws corporations are divided into three general classes: *municipal corporations*, *stock corporations*, and *non-stock corporations*.

A *municipal corporation* includes the county, town, school district, village, and city, and any other territorial division of the state with power of local government.

A *stock corporation* is a corporation having capital stock divided into shares, and which is authorized by law to distribute to holders thereof dividends or shares of the surplus profits of the corporation. A corporation is not a stock corporation because of having issued certificates of stock, which are, in fact, merely certificates of membership and which are not authorized by law to entitle the holders to dividends or a share of profits arising from the operation of the corporation. A stock corporation is either a *moneyed corporation* (one formed under the banking or insurance law), a *railroad* or other *transportation corporation*, or a *business corporation*.

A *non-stock corporation* is either a *religious corporation*, a *membership corporation*, or any other corporation other than a stock corporation.

All of these are governed by the New York General Corporation Law, but each type is organized under its appropriate subdivision. The diagram shown on page 74 outlines the system.

Our attention will be devoted principally to what are generally known as *business corporations*; that is, those corporations formed under the Stock Corporation Law other than banking, insurance, railroad, and transportation corporations.

The incorporators.—The persons who originally form a corporation are known as the *incorporators*, and it is they

Corporate Organization

General Corporation Laws.	Municipal Corporation Law.	<ul style="list-style-type: none"> County Law. General City Law. Second-Class City Law. Town Law.
		<ul style="list-style-type: none"> Banking Law. <ul style="list-style-type: none"> Banks, Trust Cos., Savings Banks, Investment Cos., Safe Deposit Cos., Personal Loan Cos., Savings & Loan Assns., and Credit Unions.
		<ul style="list-style-type: none"> Insurance Law. <ul style="list-style-type: none"> Life, Health, and Casualty Corporations. Fire Insurance Corporations. Marine Insurance Corporations. Title and Credit Guaranty Corporations. Life or Casualty Insurance Corporations upon the coöperative or assessment plan. Fraternal and Beneficiary Societies, Orders, or Associations. Corporations for the insurance of domestic animals. Town and County Coöperative Insurance Corporations.
		<ul style="list-style-type: none"> Railroad Law. <ul style="list-style-type: none"> Railroad Corporations.
		<ul style="list-style-type: none"> Transportation Corporation Law. <ul style="list-style-type: none"> Ferry, Navigation, Stagecoach, and Tramway Corps. Pipe-Line, Gas & Electric Light, and Waterworks Corps. Telegraph and Telephone Corporations. Turnpike, Plankroad, and Bridge Corps. Freight Terminal Corps.
		<ul style="list-style-type: none"> Corporations for any lawful business not embraced in one of the above.
		<ul style="list-style-type: none"> Religious Corporation Law. <ul style="list-style-type: none"> Church Corporations of any denomination.
		<ul style="list-style-type: none"> Membership Corporation <ul style="list-style-type: none"> Cemetery Corporations, Hospitals. Boards of Trade, and various other

who map out the plans for the company and file the certificate of incorporation, or who have the bill introduced into the legislature in case the incorporation is to be done by a special act. Three or more persons of full age are required to organize a corporation. The New York statutes provide that, of the incorporators, at least two-thirds must be citizens of the United States, and at least one of them a resident of the State of New York. Most of the states have very similar provisions.

The certificate of incorporation.—The *certificate of incorporation* is the document through which the corporation obtains and possesses its legal being. This certificate is presented by the proposed incorporators to the Secretary of State, together with the proper organization tax and filing fees. When the certificate is approved, accepted, and filed by him, a copy is filed by the Secretary of State in the clerk's office of the county in which the principal office of the corporation is to be located; and when the incorporators' and the directors' meetings have been held, the new corporation is legally formed.

Contents of the certificate of incorporation.—The certificate of incorporation is entitled and endorsed as follows:

Certificate of Incorporation of . . . (*name of company*), pursuant to . . . (*article and title of state general law under which corporation was founded, e.g., in New York, "pursuant to Article 2 of the Stock Corporation Law"*);

and states (according to the New York provisions):

1. The name of the proposed corporation.
2. The purpose or purposes for which it is to be formed.
3. The amount of capital stock and the number and par value of the shares of which it is to consist; or if there is to be stock without par value, the information concerning it required by law (See S. C. L., Sec. 12).
4. If the shares are to be classified, the number of shares to be included in each class and all of the designations, preferences, privileges, and voting powers, restrictions, or qualifications of the shares of each class.
5. The city, village, or town and the county in which the office of the corporation is to be located, and the address to

which the Secretary of State shall mail a copy of process in any action or proceeding against the corporation, which may be served upon him.

6. Its duration.

7. The number of directors (not less than three).

8. The names and post-office addresses of the directors until the first annual meeting of the stockholders, and if such an address is in a city, the street and number and other particular description thereof. The number of directors so named must be the number stated pursuant to paragraph 7 above.

9. The name and post-office address of each subscriber of the certificate of incorporation, and a statement of the number of shares of stock he agrees to take. If the address of any such subscriber is in a city, the street and number or other particular description thereof.

10. The statement that all of the subscribers of the certificate are of full age, that at least two-thirds of them are citizens of the United States, that at least one of them is a resident of the State of New York, that at least one of the persons named as a director is a citizen of the United States and a resident of the State of New York.

11. The Secretary of State is hereby designated as the agent of the corporation upon whom process in any action or proceeding against it may be served.

12. If the meetings of the board of directors are to be held within the state only, the certificate or by-laws must so provide.

Most of the provisions of the certificate of incorporation are self-explanatory, but a few words of explanation may be added concerning some of them.

The corporate name.—In the first paragraph, the name must be in the English language or must be one composed of English letters or characters. It must not conflict with that of any domestic or foreign corporation lawfully doing business in the state. Ordinary business corporations are not permitted to use the words *trust*, *bank*, *banking*, *insurance*, *assurance*, *indemnity*, *guarantee*, *guaranty title*, *casualty*, *surety*, *fidelity*, *bonding*, *savings*, *installment loan*,

benefit, coöperative or any derivative of *coöperative, college, university*, or the names *Lucretia Mott* or *Lloyds* (See G. C. L., Sec. 6; S. C. L., Sec. 133; Education Law, Sec. 66). Moreover, every corporate name must have "such word or words, abbreviations, affix or prefix therein or thereto as will clearly indicate that it is a corporation as distinguished from a natural person, firm, or copartnership" (See G. C. L., Sec. 6). The custom is to use the word *corporation*, or *incorporated*, or an abbreviation of one of them.

Corporate powers.—Under paragraph 2 are stated in detail the purposes which the corporation wishes to accomplish. These are usually made very broad and inclusive. The corporation is authorized to do all the things specified in the certificate, and they are usually called the *powers* of the corporation. Those things especially set forth in the certificate are known as the *expressed powers*; but the corporation is, in reality, not limited to these, as it has also what are known as *implied* and *incidental powers*. If it is clear that certain additional powers are necessary in order to carry out those powers which are expressed in the certificate, such powers are *implied*. Further, it may be that in the process of expanding its business, the corporation may discover that its profits will be increased or its main business protected if it engages in activities which are in the nature of side lines or related activities. Powers assumed to carry out such purposes are known as *incidental powers*.

A familiar illustration will make these clear. Suppose a company is incorporated with the *expressed* powers to buy, sell, deal in, tan, prepare, and manufacture leather. Now while the certificate may not say so, it is *implied* that the company may own property; borrow money; have a corporate seal; execute contracts, leases, and other legal documents; and so on. Also, *incidental* to the leather-tanning and manufacturing business, the company may buy or raise forests, and from the trees strip the tanbark for its use. Having done this, it may dispose of the trees as wood or lumber, establishing mills for cutting if necessary. The Hudson River Day Line, a steamship corporation, aids its steamship business through the operation of a woodland recreation park at a convenient distance from New York

City. In the park, restaurants and various amusement and recreational facilities are provided. This business is incidental in that it attracts to the steamship line passengers who may wish to spend a day at the park. These incidental powers are sometimes very important, and the by-products sold under such powers are very profitable. Within the limitation of its powers, the corporation is free to act, but it is not permitted to exceed them. Any act committed outside of the corporate powers is known as an *ultra vires act*, and is illegal.

Duration of a corporation.—The third, fourth, and fifth paragraphs need no explanation; and as to the sixth, all that need be said is that the life of a corporation and the certificate may be, and usually is, made perpetual, although any term of years may be named as the life period.

General provision of the certificate of incorporation.—The remainder of the eleven paragraphs are sufficiently clear, but attention is called to several things which, while not required, are permitted and often used in the certificate. Subdivision 2 of Section 10, General Corporation Laws of New York, provides: "The certificate of incorporation of any corporation may contain any provision for the regulation of the business and the conduct of the affairs of the corporation, and any limitation upon its powers, or upon the powers of its directors and stockholders, which does not exempt them from the performance of any obligation or performance of any duty imposed by law." Experienced organizers utilize this provision for the purpose of giving stability to the corporation and protection to the stockholders by inserting rules for the internal management of the corporation, such as giving the corporation the right to hold and dispose of stock of other corporations; giving the corporation a lien on the stock of a member indebted to it; regulating the amount of working capital and the manner of declaring dividends; and providing for cumulative voting, for committees of directors, for classifications of directors, and other desirable features.

Certificate of incorporation a contract.—The certificate of incorporation is, for all intents and purposes, a *contract* between four parties: the state, the corporation, the stock-

holders, and the creditors. Each of these parties to the contract has certain *rights* and *obligations*, except the creditors, who, of course, have only rights and no obligations. These rights and obligations can be set forth briefly as follows:

The state—

Right:

To collect taxes and to exact obedience to its laws.

Obligation:

To permit the corporation to exist as a legal entity.

The corporation—

Rights:

To exist as a corporate entity and have continuous succession.

To buy, mortgage, and sell property, real and personal, necessary to the company's business.

To sue and to be sued in its own name.

Obligations:

To obey the laws and submit to the visitatorial powers of the state.

To give stockholders their rights.

To pay its debts.

The stockholders—

Rights:

To receive dividends.

To vote for directors and, also, to vote generally on all matters affecting at one time all the corporate property.

To share in the proceeds of dissolution.

To be faithfully represented by the directors.

To inspect the corporate books.

Obligations:

To pay for stock as agreed.

To meet such special obligations as are imposed by statutes, such as:

(a) To pay for the benefit of creditors the difference between the par value of the stock and the amount paid thereon.

(b) To guarantee the payment of wages to the corporation's laborers.

The creditors—

Rights:

To receive payment of debt from the corporation.

Usually, to inspect the books if the debt has been reduced to a judgment.

To collect from stockholders if:

(a) Claim is for wages.

(b) Stockholders have not paid par value for their stock.

The complete charter.—A *charter* represents a grant of authority; hence, the complete charter of a corporation consists not only of its certificate of incorporation, but also of all the laws upon which this certificate rests. Thus, the charter of a business corporation would consist of the certificate of incorporation, resting upon the stock corporation law, resting upon the general corporation law, resting upon the state constitution, resting upon the United States Constitution. Any provision of any one of these which violates a provision of an underlying one is, of course, void.

The corporate by-laws.—Still another instrument for the government of the corporation is the *by-laws*, which are, in reality, a set of rules adopted by the corporation to govern its internal operation, usually covering such matters as the management of the property; the transfer of its stock; the calling of meetings of the members; the fixing of the amount of stock which must be represented at the stockholders' meetings in order to constitute a quorum, unless otherwise provided by law; the setting forth of the names and duties of the offices of the corporation, and other matters of management not inconsistent with existing law. Such by-laws adopted at the meeting of the stockholders of the corporation control the action of its directors.

Other classifications of corporations.—As heretofore shown in this chapter, the law looks upon corporations as being of three classes: *municipals*, *stock corporations*, and *non-stock corporations*, each with its various subdivisions. But this is not the only classification. There are several other groupings of types which tend to show various attributes of corporations.

There is the classification based upon the relative extent to which state and private control and interest are involved:

1. Public corporations:
Cities, counties, towns, road districts, etc.
2. Quasi-public corporations:
Those possessing a franchise to use public property for public service but also for their private gain. This class embraces the large public service group.
3. Private corporations:
Those formed strictly for private business and private gain.

Again, there is the grouping indicating the kind of business done, the product turned out, or the service rendered:

1. Railroads.
2. Public utilities.
3. Industrials.
4. Extractive businesses.

Finally, there is the grouping based upon the place of incorporation:

1. Domestic corporations:
A corporation is domestic in the state in which it is incorporated. It may be incorporated in more than one state.
2. Foreign corporations:
A corporation is known as a foreign corporation in every state other than that in which it is incorporated.
3. Alien corporations:
Alien corporations are those of some country other than the one in which they are doing business. Corporations of other countries are admitted under the laws governing admission of corporations from other states.

Corporation taxes.—Corporations are generally subject to two forms of tax, a preliminary or organization tax and an annual tax. The Federal Government imposes an in-

come tax and a capital tax upon corporations, and also, in some cases, an excess profits tax. There is, strictly speaking, no preliminary or organization tax imposed by the Federal Government, but there is a tax of ten cents upon every hundred dollars of par value of issued capital stock, or in case of no par value stock, ten cents a share.

In New York, there is an organization tax imposed upon domestic corporations and a license tax imposed upon foreign corporations. The organization tax is five cents for each hundred dollars of authorized capital stock, and in the case of no par value stock, five cents a share. The minimum in either case is \$10. These taxes are not to be confused with the filing fee paid to the officer with whom the certificate of incorporation is filed. In New York, this fee is \$40. The annual tax imposed by the states may be either an income or a franchise tax, that is, a privilege or an excise tax.

In New York, corporations are divided into several classes and it is the class into which the corporation falls which determines the nature of the tax to be imposed. Even in the case of ordinary business corporations, there are four methods of assessing the tax. In New York, foreign and domestic corporations are taxed upon approximately the same basis. In some instances the state taxes are progressive, but this is not the case with either the New York franchise tax or the Federal income tax. There are also state and federal taxes on the transfer of shares.

Difficulties in corporate formation.—Many business men are deterred from organizing their company into a corporation because of the alleged difficulty of so doing. As a matter of fact, the corporate formation presents very few difficulties to those learned and experienced in the field, but, of course, should not be attempted by those not thoroughly conversant with the laws and practices. Many lawyers, as well as incorporating companies, specialize in doing incorporation work and will attend to all the details for a very reasonable fee. The person who is inexperienced in matters of this sort had better utilize such expert assistance, not because he could not, in all probability, draw up a certificate of incorporation which would be accepted, but rather be-

cause he ought to make sure that he has therein all the provisions that he is entitled to for his own protection and welfare.

Liability of corporate stockholders.—One of the distinguishing features of the corporation is the limited liability of its members. It has already been seen that individual proprietors are fully liable personally for all the debts of their business, and that members of general partnerships, general partners in limited partnerships, members of joint-stock companies, and members of certain types of business trusts are jointly and severally liable for all the debts of their companies; but, generally speaking, stockholders in corporations are not liable for any of the debts of the firm, and the greatest loss they can suffer by disaster to the business is the loss of the investment made by them. There are minor exceptions to this general statement. A stockholder possessing stock for which the issuing company has not been paid up to the full par value is liable to the firm's creditors for the amount of the unpaid portion on his shares for any debts contracted by the corporation while he held such shares. There are many minor variations in the several state laws in regard to this; but the New York law provides that if a stockholder disposes of his part-paid stock, he is still liable, as above, for the period of two years after such disposition, provided the creditors bring proper suit against him within that time.

Stockholders are also jointly and severally liable for all debts due and owing by their corporation to any of its laborers, servants, or employees, other than contractors, for services performed by them for such corporation, provided suit is brought in the prescribed manner (See S. C. L. of N. Y., Sec. 71).

The management is delegated.—The authority and responsibility for the management of the corporation are delegated by the stockholders entirely to a board of directors, which is elected periodically by the stockholders' votes. Beyond electing these directors and having the right to vote on certain questions concerning at one time all the corporation's property, such as sales, leases, change of capitaliza-

tion, consolidation, and so on, the stockholders take no active part in the management. As a matter of fact, many of them rarely know very much concerning it.

The corporation has stability.—The corporation has to a very marked degree the characteristic of stability so much to be desired in business forms. Having continuous succession, its life is unaffected by the transfer of shares or by anything which may happen to a shareholder or a director. War between nations represented by the stockholders does not affect the status of the corporation. There is no *delectus personæ*, and new members may enter at any time simply by taking over the stock of old holders. It ends with the lapse of the period of life specified in the certificate of incorporation, and can be dissolved by a court for non-use of franchise, breach of the law, or fraudulent or illegal acts. With these few perfectly normal exceptions, it may be said to have practically perpetual as well as continuous life.

Flexibility.—The corporation is extremely flexible in regard to the important features of expansion, management, and movement.

Being able to raise large amounts of capital, it can expand along its present lines to almost any desired extent; and through broad charter powers, it is enabled to go into many related or incidental lines.

The management, being in the hands of a few directors with absolute authority, lends itself readily to whatever changes in methods of management the directors see fit to make.

By meeting the rather simple requirements of filing information and of paying foreign corporation fees and taxes, the corporation can enter and do business in any state or states, thus enjoying the greatest possible flexibility of motion.

Legal status of the corporation.—The status of the corporation as a legal entity or fictitious being, with continuous existence, transferable ownership, delegated managerial authority, and limited liability of members, is thoroughly established in all of the states. Despite this, however, the statutes of the several states in regard to corporations differ very widely in detail, thus causing a great deal of trouble

and uncertainty where a corporation may be concerned with more than one state. There is nothing in respect to corporations that corresponds to the Uniform Partnership Law for that form of organization.

Government control.—Corporations are more subject to governmental control and supervision than any other form of business organization. They are closely watched by, and are subject to, the visitorial powers of the state and, in some instances, the national government. They are heavily taxed and have to render multitudinous reports. Some states are much more liberal than others in their treatment of corporations, and these are profiting by becoming the great “incorporating states.”

Advantages and disadvantages of the corporate form.—The principal advantages and disadvantages of the corporation as a form of business organization may be tabulated as follows:

✓ **Advantages:**

1. Possibility of aggregating large sums of capital.
2. Limited liability of stockholders.
3. Continuous succession.
4. Marketability of ownership.
5. Adaptability to efficient organization, and flexibility of expansion and motion.

✓ **Disadvantages:**

1. Formation is complicated and requires services of an expert.
2. Stockholders usually have little voice in the conduct of the business.
3. Non-uniformity of the corporation laws of the various states causes difficulty.
4. Strict governmental control and heavy taxation are burdensome.

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Questions for Study and Review

1. Give a definition of a *corporation*; make your definition embody the modern concept of the term.
2. Name the three classes of corporations provided for by the New York statutes, and explain each.
3. What information must be given in the certificate of incorporation?
4. Name and explain the three kinds of powers possessed by a corporation.
5. Name the parties to the contract of incorporation, and state the rights and obligations of each.
6. What is the purpose of corporate by-laws?
7. How are corporations classified:
 - a. On the basis of the relation to the state?
 - b. On the basis of the produce, or the service rendered?
 - c. On the basis of the place of incorporation?
8. Explain in detail the limited liability of stockholders in a corporation.
9. Explain the stability of the corporate form of organization.
10. Name the advantages and disadvantages of the corporation as a form of business organization.

Problems

1. By means of a diagram show the complete charter of each of the following:

- a. A city.
- b. A trust company.
- c. A fire insurance company.
- d. A railroad.
- e. A manufacturing company.

2. *a.* Messrs. Allen, Babson, and Conway own all of the stock of the Home Development Corporation, which agreed to sell a large piece of its land to Mr. Dawson. The deed, signed by all three of the stockholders, is delivered to Mr. Dawson. Does Mr. Dawson get title to the land? Why?

b. Messrs. Ames and Bullard, partners in a retail business, sell out their business to Mr. Young, pledging him that they will not again engage in the same business under their firm name. Soon after the sale, however, they incorporate the Ames and Bullard Company, in the same kind of business. Can Mr. Young restrain them on the basis of the contract or on any other principle?

3. Mr. Ambrose recently bought 50 shares of the \$100 par value stock of the Monarch Shoe Manufacturing Company, Inc. He paid \$2,500 in cash for 25 of his shares. He bought the remaining 25 shares on a part-payment plan, paying \$250 in immediate cash and making three subsequent payments of \$125 each. The company then failed. What, if any, are Mr. Ambrose's liabilities on account of his stockholdings in the Monarch Company?

4. *a.* Suppose that all of the stockholders of a corporation died. The directors are not stockholders, not being required to be such in this company. What steps should the board of directors take?

b. Suppose the same thing happened in a joint-stock company and in a Massachusetts Trust. What would the board of governors and the board of trustees, respectively, do?

5. Draw up a certificate of incorporation for a manufacturing corporation.

CHAPTER VI

Managing a Corporation

Board of directors.—The ownership of most corporations is divided among a large number of stockholders, usually hundreds and often thousands, and the impracticability of getting all of these together at rather frequent intervals to do any actual management of a business is easily recognized. The law, therefore, authorizes the delegation of corporate management to directors, elected periodically by the stockholders. The number of directors varies in different corporations, and is fixed for each by its certificate of incorporation or its by-laws. All of the directors taken together constitute the *board of directors*, which is the governing body of the corporation and which is entirely responsible for the management of the business.

The board of directors elects from its own membership its chairman and its important committees, such as the executive committee, the finance committee, and the proxy committee. It also appoints the officers of the corporation, including the president, the vice president, the treasurer, the comptroller, the auditor, the secretary, and others.

This board directs the general business and policies of the company and supervises the work of the officers. It does not, of course, attempt to carry on the details of business operation. Leaving these to the officers and employees, it maps out policies and principles, and settles all matters brought before it by the officers and the committees. It may exercise all the powers given to it by the certificate of incorporation and the by-laws, and may transact, ordinarily, all general business matters pertaining to the welfare of the company. The laws of most states, however, provide that certain matters affecting very widely the interests of all concerned, such as changing the number of directors; mort-

gaging, selling, or leasing property; changing the place of business; changing capitalization; changing classifications of stock; and other matters of similar scope, can be done only with the consent of the stockholders and usually only upon a vote of a large part of them, often two-thirds or three-fourths.

All actions of the directors in the management of the corporation must, to be effective, have their origin in a *board meeting*. That is to say, no director or group of directors can transact any company business except at a regular or special meeting of the board at which a quorum is present. Moreover, a member of the board cannot vote therein by proxy or by mail.

Meetings of the board of directors are provided for under certain rules in the by-laws, and are usually held monthly. Directors, as a rule, do not receive salaries but are often paid a stipend or fee for each meeting attended. Some corporations, however, do pay their directors regular salaries. The remuneration of directors should not be decided by themselves but should be provided for in the by-laws, or fixed by a vote of the stockholders.

The board of directors is not permitted to bind its corporation by contracts with individual members of the board, unless it can be shown that such contract is beneficial to the company, and that the terms are fair.

Committees of the board.—The *executive committee*, usually made up of very capable members of the board of directors, devotes considerable time to the management of the company's business. It meets more often than does the board of directors, and transacts a large amount of the routine business between the meetings of the larger body. In many of the larger corporations, the members of this executive committee are at the offices of the corporation at all times, and are paid a regular salary for exercising their managerial functions.

The *finance committee* is the name given by some corporations to their executive committee, although other corporations have the two committees under their respective names. The finance committee has special charge and control of all the financial affairs of the company.

The *proxy committee* is made up of members of the board of directors, and at the meetings of the stockholders it represents, and votes for, those who authorize it so to do. By receiving the proxies or the voting powers of a large number of stockholders, this committee often exercises a tremendous power in the stockholders' meeting and thus gives the board of directors, of which it is a part, a strong hand in the control of the company—a point which will be discussed later in this chapter.

Corporate officers.—The *chairman* of the board of directors not only acts as the presiding officer of the board when it is in session, but also exercises very important control over the affairs of the company in general. He is usually a bigger man than the president, and may give instructions to him. He interests himself not only in a general way in the internal workings of the business, but also devotes a large part of his energies to maintaining proper relations between the corporation and those with whom he comes in contact on the outside.

The *president* is the chief executive of the company, and is responsible for its proper internal management and operations. All departments, through their respective heads, are responsible to him. The laws of some states require that he be selected from the membership of the board of directors, a fact which, of course, enables him to keep the board in close touch with the workings of the business.

The *vice president* in smaller companies is intended to be a substitute for the president in his absence or incapacity, and is usually given minor duties in assisting the president. In larger corporations, however, there are frequently a great many vice presidents, each of whom has definite and important duties. They are usually the responsible department heads; we often see such titles as "Vice President in Charge of Production," "Vice President in Charge of Purchasing," "Vice President in Charge of Sales," "Vice President in Charge of Personnel," and so on.

The *treasurer* has custody and charge of the funds and securities of the company; he has the right to sign checks for payment of obligations and, also, to endorse for the company its checks, notes, and other obligations. He is respon-

sible to the finance committee of the board of directors. The credit and collection departments are generally under the supervision of the treasurer. In the larger corporations, there are both comptroller and auditor, as described below, but in the smaller companies the duties of both of these officers are often performed by the treasurer or his clerks.

The *comptroller* is the principal officer in charge of the accounts of the company. He has supervision of the book-keeping, accounting, auditing, and reporting procedure. All reports concerning financial conditions should be approved by him. He is generally counted upon by the finance committee to do a large part of the financial planning and budgeting for the company.

The *auditor* examines the books and records of the business to see how the funds have been used and to determine the financial status of the business, which is to be shown in a balance sheet, and the result of operations to be brought out in the profit and loss statement. He should keep the directors informed as to the financial condition of the company.

The *secretary* keeps the minutes of all meetings—including those of the directors, the stockholders, and the various committees—and has charge of the records. He is generally authorized to sign with the president, all contracts, leases, mortgages, bonds, stock certificates, and other such documents, and to affix the corporate seal. He has charge of the certificate books, transfer books, and stock ledger. He is usually provided with one or more assistants to assist him in this work.

Stockholders in management.—The stockholders are those who actually own the stock of the corporation; they thus constitute the real owners of the business, but their share in the management is generally small, except indirectly through their right to choose the directors. They form, of course, a body entirely separate from the board of directors, although the directors individually are often holders of large amounts of stock. In fact, in some companies all of the stock is owned by members of the board of directors, or, to put it another way, every stockholder is on

the board of directors. This is possible only where the stock is very closely held. Even in a case such as this, however, the duties and powers of these persons when assembled as stockholders are quite different from those which they have as directors, and all the rules and laws for the two bodies must be observed just as carefully as though there were no interlocking whatever.

The stockholders generally delegate to the directors all the rights of management, except those few which the laws provide can be exercised only by consent of a certain portion of the stockholders, as previously mentioned in this chapter. If directors do not manage the affairs of the company to suit the wishes of the stockholders, the latter can show their superior power of control by electing new directors in their places at the expiration of their terms. In the meantime, however, the stockholders are powerless to control the actions of any members of the board unless they can be shown to have acted in bad faith or in an illegal manner, in which case they can be removed by court order.

From a practical standpoint, it is frequently quite difficult for stockholders not on the board of directors to control the board, even by election, owing to the fact that in many companies board members own a very large part of the stock and practically dominate the stockholders' meetings and elections. Even in cases of this kind, however, if the minority rights are infringed, the courts can be called upon to compel the majority to give the minority its legal rights.

Stockholders' meetings.—The *regular meetings* of stockholders for the election of directors and the transaction of other business are usually held annually, but *special meetings* for special purposes may be called at other times. The rules governing such meetings are embraced in the by-laws of the organization. Any business may be transacted at regular meetings, except such matters as the law provides can be taken care of only at special meetings called for the purpose. Actions requiring specially called meetings are generally such as are concerned with (1) changes in the purposes or powers of the corporation; (2) changes in respect to the capital stock or capital, such as increasing or reducing the amount of capital stock, increasing or reducing the par

value of its shares, increasing or reducing the number of shares, changing certain shares from par value to non-par value shares or vice versa; (3) changes in the number of directors; and (4) changes in the location of the office. Some of these acts can be consummated by the board of directors without a stockholders' meeting, providing the unanimous consent of the stockholders has been obtained by mail or by personal solicitation; but if the matter is taken to a meeting, it must be a special one called for the purpose. It is well to remember, also, that special meetings can transact only that business for which they are called (S. C. L. of N. Y., Secs. 35, 36, 37, 38, 45).

The by-laws provide what number shall constitute a quorum for the transaction of business at regular stockholders' meetings. No quorum is necessary, however, at *special* meetings for the election of directors. For this purpose, the laws of most states provide that those present at the meeting, regardless of number, may elect.

Voting.—Presumably, every corporate stockholder has a right to vote for directors; but, as a matter of fact, there exists a great amount of *non-voting stock*, the holders of which do not have voting rights. Of course, a corporation has no right to deprive any stockholder of his voting privilege; but it can, and does offer for sale *non-voting stock*, by the purchase of which the stockholder voluntarily waives his voting rights in so far as these shares are concerned (See Chapter VII). Therefore, it is the holders of the voting stock alone who, through their rights to vote for directors, have control of the corporation.

There is a third class of stock known as vetoing stock, which, while it does not give the owner the right to vote on all questions as does the voting stock, nevertheless entitles him to vote on certain specified questions or in the event of certain conditions coming to pass (See Chapter VII).

Since the control of the personnel of the board of directors through the voting power is the only method by which the stockholders can even indirectly influence the management of the corporation, it is important that they should have a clear understanding of their rights and powers at elections

and of the several methods by which the voting may be carried on.

In the early days of American corporations the stockholders used to vote under the common law, which gave one vote to each stockholder regardless of the number of shares that he owned. Thus, under the *common-law voting*, two stockholders owning one share each could out-vote one holding 1,000 or even any number of shares.

Later on, it became recognized that a corporation was more an aggregation of capital than an association of individuals, and it was considered to be a fairer distribution of power if each shareholder were given votes in proportion to the amount of money invested by him. Various states then enacted laws giving the stockholder one vote for each share of stock held by him. This type is known as *statutory voting*. It is the opposite of common-law voting and places disproportionate control in the hands of a few men who may each own a very large portion of the stock. To avoid this situation, some corporations, in states where the laws permit it, have adopted a species of sliding scale in their voting arrangement, following out a plan originated in England. While any scale may be agreed upon, a very common one gives the stockholder one vote for each share that he owns up to 10 shares, an additional vote for every additional five shares up to 100 shares, and an additional vote then for every additional ten shares above 100 shares. Some few corporations have provided for a maximum number of votes to be cast by one stockholder regardless of the number of shares he may own. This method of enfranchisement is, however, very little used in the United States.

Another method of voting, known as *cumulative voting*, is made compulsory by the laws of some states, and is permitted in others, including New York, if it is provided for in the certificate of incorporation. Under this system, at all elections of directors, each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock multiplied by the number of directors to be elected; and he may cast all such votes for a single director, or he may distribute them among the total number to be voted

upon or among any two or more of them, as he may see fit. An understanding of this cumulative method of voting and of its method of operation is very important in the control of the modern corporation.

Cumulative voting.—Mr. Madison, who owns 20 shares of stock in Corporation A, which is to elect five directors, is entitled to 100 votes (obtained by multiplying 20, the number of shares owned, by 5, the number of directors to be chosen). There may be any number of nominees from which Mr. Madison may select the five he prefers and give 20 votes to each of them. If he prefers, however, he can give 25 votes to each of four of the candidates, 50 votes to each of two, or the entire 100 votes to any one, thus strengthening the chances of the election of his choice. He is not limited, of course, by these divisions of his votes, but can apportion them in any manner whatever.

A stockholder or group of stockholders may be desirous of electing a certain number of directors of their own choice, and it is of value to them to know in advance just how many directors can be assured of election by the votes from the stock which they have, or how many additional shares will be necessary to elect the group they wish. A number of convenient formulas have been derived to determine this, of which the following may be taken as an example:

$$X = \frac{ac}{b + 1} + 1.$$

In this formula, a represents the total number of voting shares of stock outstanding; b , the total number of directors to be elected; c , the number which the particular group wishes to elect; and X , the number of shares it is necessary to hold to elect c out of b directors.

Let us suppose that the M Corporation has 1,000 shares of voting stock outstanding and that there are nine directors to be elected. Mr. Weston, a stockholder, wishes to be certain of the election of five of them. How many shares of stock must he control? Substituting in the above formula, we have:

$$X = \frac{1000 \times 5}{9 + 1} + 1 = \frac{5000}{10} + 1 = 500 + 1 = 501.$$

Thus, if he controls the votes of 501 shares, he can be certain of electing his five out of the nine directors, provided he distributes his votes as evenly as possible among them. Similarly, we may find that in order to elect four directors, he would need 401 shares; to elect three, he would need 301 shares; and so on. Thus, if he has set his mind on the election of any particular number of directors, he knows just how many shares he may be short of the required number and he can set about acquiring the necessary remainder.

On the other hand, he may not wish to acquire any additional stock; he may simply want to know how many directors he can be sure of electing with the stock he has, and thus know among how many of the candidates he may safely divide his votes. Presume, for example, that in this same company he owns 425 shares. Then, in the formula, the 425 takes the place of the X , and the number he can elect, represented by c , becomes the unknown quantity. The equation, then, takes the form and solution indicated below:

$$\begin{aligned} 425 &= \frac{1000c}{9 + 1} + 1. \\ 425 &= 100c + 1. \\ 424 &= 100c. \\ c &= 4.24 \end{aligned}$$

Thus Mr. Weston, with 425 shares, could mathematically elect almost four and one-quarter directors, but could actually, of course, elect only four, and could not be prevented from so doing provided he divided all of his votes properly among them.

As a matter of fact, it would require only 401 shares to elect the four directors, and if these were all he wished to elect he would be able to dispose of 24 shares of his stock and still not weaken his chances at the election.

Voting by proxy.—If a stockholder is not present in person at any meeting, he is permitted to have someone attend for him and vote his stock. This is called *voting by proxy*, and the person who acts for the stockholder is called his *proxy*. *Proxy* is also, however, the term generally applied to the written authorization which the stockholder gives to another person to represent him and to vote his stock.

Legally a *proxy* is a power of attorney transferring the right to vote without transferring the share. These proxies must be executed by the stockholder himself, or his personal representative, and can be revoked at any time by the person executing them. They are often made out to cover some particular meeting, but can be made out so as to cover any meetings that may occur within a given time. In New York, the stockholder can make the proxy run as long as he wishes, provided he specifies some period limitation. If he does not prescribe any limited period, the proxy is void eleven months after its date of execution. In New Jersey, a proxy cannot be made for a longer term than three years.

The following is a customary form of proxy:

PROXY KNOW ALL MEN BY THESE PRESENTS, That the undersigned stockholder of hereby constitutes and appoints, and each of them, the true and lawful attorneys and proxies of the undersigned, with power of substitution, for and in the name of the undersigned, to vote at the annual meeting of the stockholders of said Corporation to be held on, and at any and all adjournments of said meeting, all of the shares of the capital stock of said Corporation standing in the name of the undersigned on, in each case with all the powers the undersigned would possess if personally present. A majority of such attorneys and proxies as shall be present and shall act at the meeting may exercise all the powers of all of said attorneys and proxies hereunder.

Witness the hand and seal of the undersigned this day of 1939.

No.

..... (L.S.)
(Signature of Stockholder)

When, in the very large corporations, the stockholders are widely scattered, the board of directors appoints from among its number what is known as a *proxy committee*. Enclosed with the notice of the meeting, there is generally sent to each stockholder a printed form of proxy authorizing this proxy committee to act for the stockholder. For the great number who cannot attend the meeting, the easiest thing to do is to execute and return this form. An addressed and stamped envelope is usually included for this purpose. Thus, the proxy committee often comes to the meeting with the voting rights to thousands of shares of stock; and this, in addition to the stock naturally owned by members of the

stockholders' meeting, and enables it to carry out things as it wishes and often to perpetuate itself in office.

Often the board of directors is believed to abuse this use of the proxy. Consequently, some stockholder not on the board will challenge the practice, writing to the various stockholders to give him their proxies so that he can, in their behalf, oppose the members of the board at the stockholders' meeting. In this attempt to oppose the directors, however, he is rarely successful, as the stockholders are, as a rule, suspicious of individuals asking for their proxies. They usually like to give them to those in authority, especially if the present management is successful and the business is yielding a fair dividend.

Power and protection of the minority.—The maxim "The majority rules" is seldom true in regard to a body of stockholders of a corporation. When one speaks of the *controlling interest* in a company, one usually means the ownership of at least 51 per cent of the stock. From a practical standpoint, however, it is rarely necessary to own such a large part of the stock in order to control the company. Less than 51 per cent of the stock of a corporation will generally assure control, for one or more of the following reasons:

1. Stock may be, and usually is, divided into voting and non-voting classes. These classes may occur in varying proportions in various companies, and the most common custom is to make the common stock voting and the preferred stock non-voting, though this is by no means universal.¹ If in a certain corporation 50 per cent of the stock is voting and 50 per cent non-voting, it is quite evident that, whatever the other circumstances, a majority of the voting stock or rather 26 per cent of the entire stock, would exercise control.

2. Regardless of what portion of the stock may have the voting power, a considerable minority of the voting stockholders may be closely organized and in agreement to vote together on certain questions, or at an election. The remainder may be unorganized, and their votes divided in several ways. Presume that about 30 per cent of the votes are

¹In recent years, many organizations have issued non-voting common stock, reserving the voting control to the preferred stock, generally held by the organizers. For an interesting description of, and attack upon, this

banded together and that the other 70 per cent have no organization. If the 70 per cent are divided in several ways, the minority will very likely carry their points. Of course, the larger the minority and the more they can divide up the votes of the majority, the better is their chance of prevailing.

3. A minority of stock may constitute a majority of the stock actually voting. In the two cases above, we have assumed what is most improbable; namely, that all the voting stockholders are represented at the meeting either in person or by proxy. As a matter of fact, it is very unusual, except in fairly small organizations, to have more than 75 per cent of the stock represented at a meeting. In such a case a minority consisting of 38 per cent of the voting stock would control the meeting, even though all the remaining stock present were united against it.

4. The directors, who frequently own rather a small minority of all the voting stock, often gain control by procuring proxies for their proxy committee, as explained above.

Influential groups of stockholders other than directors frequently use the same system. In smaller corporations, the secretary is often the one who seeks and obtains the proxies of the stockholders, casting the votes, of course, according to the wishes of his immediate employers, the directors.

5. Sometimes stock votes by classes, and a minority class may be given the privileges of choosing a majority of the board of directors. Consider the case of a company whose common stock represents 60 per cent and whose preferred stock represents 40 per cent of the whole. If there are nine directors, it may be so arranged that the preferred stock always chooses five of them and the common stock the remaining four. In such a case, the majority of the preferred stock, which is about 21 per cent of all the stock, can elect a majority of the directors, and thus control.

6. Stock with a strict vetoing power exerts a strong negative control over various affairs of a company. A certain class of stock (presume it to consist of about 20 per cent of the total) may be classified as non-voting for ordinary purposes, and yet the certificate of incorporation may provide that certain things may not be done without the consent

of the majority of this class of stock. In such a case, the holders of the majority of this stock, which would be only about 11 per cent of the entire stock, can absolutely block action on the part of all the remainder.

7. In states where the statutes do not prohibit such action, certificates of incorporation sometimes provide that more than a majority of the total vote shall be required to perform certain acts, such as the election of directors, the necessary portion being sometimes $\frac{3}{5}$, $\frac{2}{3}$, or $\frac{3}{4}$. In such cases, a minority once in power, can remain in control by blocking elections and other actions requiring the large vote.

Protection through cumulative voting.—Cumulative voting assures to holders of comparatively small amounts of stock at least some representation on the board of directors. They are assured this representation through no other voting method. Let us consider again the Corporation *M*, mentioned under *cumulative voting*. In this corporation there are outstanding 1,000 shares of voting stock. Suppose that one group of stockholders holds 501 of these shares and another group holds 499 of them. Under the statutory method of voting, the larger group could cast the votes of 501 shares for the first candidate put up, against the votes of 499 which the smaller group could cast for its choice. They could do the same with the second, and the third, and so on, until they had elected the entire nine directors, thus leaving the large minority with no representation whatever on the board. Under the cumulative plan of voting, however, the smaller group could elect (See page 96) four of the directors, while the larger group could elect five. This is, of course, a fair representation. If there were a stockholder or group of stockholders holding as few as 101 shares, they could, by concentrating their votes on one candidate, elect him to the board and thus get representation.

Controlling through voting trusts.—It is sometimes desired to place the control of all or part of the stock in the hands of one person or of a few persons. This may be done through a *voting trust* agreement. Under this agreement, any number of stockholders transfer their stock to a *voting trustee*, or to voting trustees, by whom the stock is held and

voted at the stockholders' meetings. The old certificates are canceled and new ones issued in the names of the voting trustees. The real owners of the stock are given voting trust certificates to show that they are in reality the owners of the shares held by the voting trustees, and are thus enabled to claim their dividends when they are collected by the trustees and to redeem their stock at the expiration of the trust.

These certificates, sometimes called *certificates of beneficial interest*, are negotiable, and are frequently listed and dealt in on the exchange. One of the principal prerequisites for the formation of a voting trust is that it must be open to all stockholders of the company who desire to participate. Conditions relative to the trust differ slightly in the several states. In New York, for instance, it cannot exceed a period of ten years, while in New Jersey there is merely the requirement that some certain time limit be set. Since 1925, it is no longer legal in New York State for stockholders of banking corporations to form voting trusts.

This form of control is often resorted to when a business is in financial difficulties. If a corporation is unable to pay certain obligations, such as interest on its bonds, or perhaps principal, the bondholders may forego the foreclosure and extend the time for payment, provided the business can be put under the control of themselves or their representatives. In such a case a voting trust could well be formed, the voting trustees being named by the creditors. If, under the management of the trustees, the business is made to prosper and pay off its debts, the trust will be dissolved and the control given back to the stockholders.

At the very start of a business in order to keep the control and management in the hands of the originators until the business has had a chance to become established, a voting trust is sometimes used by a corporation instead of turning the control over to a large number of stockholders.

Controlling through holding companies.—The stock of a corporation may, in some jurisdictions, be owned and held by another company instead of by individuals as stockholders. Such a company, holding the stock of another corporation (and generally the stock of several other corporations at the same time), is known as a *holding company*; it draws divi-

dends upon, and votes, the stock it holds, just as an individual stockholder would do. This arrangement places the control of the company indefinitely in the hands of a small group, the directors of the holding company, whereas the device of the voting trust does so only during the limited life of the trust. Holding companies will be discussed more fully later.

Corporate books and records.—The management of a corporation must maintain two classes of books or records, known respectively as the *corporate books* and the *financial books*.

Corporate books consist of the minute books for all meetings—directors', stockholders', and committees'; the stock book, a detailed record of all stock transactions; and the transfer book, usually consisting of stubs of the issued certificates bound in the certificate book. The stock book should contain the names of all persons who are stockholders in the corporation, showing their place of residence, the number of shares held by each of them, the time when they respectively became owners thereof, and the amount paid thereon.

The *financial books* are the ordinary books of account used in recording the financial transactions of the corporation. They are similar to those used in any other business.

Statutes usually provide that the corporate books must be open for the inspection of stockholders, with certain regulations, and they provide a penalty for refusal to allow such examination. The financial books, however, are not open to the inspection of the stockholders. Corporations usually issue an annual or semi-annual financial statement showing their condition, and from these statements stockholders can generally get desired information concerning the finances of the corporation. Under most statutes, however, holders of a certain percentage of the stock may demand at stated intervals a special sworn statement from the treasurer in addition to the regular statements.

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Questions for Study and Review

1. What are the functions and duties of the board of directors of a corporation?
2. Name the principal committees of a board of directors, and tell the functions of each.

3. What are usually the principal officers of a corporation, and what are their respective duties?
4. Name and describe three methods of voting for directors used by stockholders in corporations.
5. Describe in detail the right of proxy.
6. Mention at least five ways by which ownership of less than 51 per cent of the stock may give control of a corporation.
7. How does the system of cumulative voting assure the minority a representation on the board of directors?
8. Describe a voting trust, and tell what purposes it serves.
9. Describe a holding company.
10. What books must be kept by a corporation? How are they classified? Do stockholders have free access to them?

Problems

1. The by-laws of the Jackson Manufacturing Company, a corporation, provide that "at any meeting of the stockholders, a majority of the capital stock of the company, present in person or represented by proxy, shall constitute a quorum for all purposes, unless the representation of a larger number shall be required by law, and, in that case, the representation of the number so required shall constitute a quorum." This company has only 200 shares of stock, of which Mr. August owns 100 shares and Mr. Bentley 100 shares. Of the three directors, Mr. August controls two, and Mr. Bentley one. The annual meeting for the election of directors is about to be held, but the stockholders have had a disagreement and each wants to get control of the majority of the directors. What can Mr. August do to insure a continuation of his control? Under what circumstances might Mr. Bentley get control?

2. *a.* You have given your proxy for a forthcoming stockholders' meeting to a friend, believing that you will be unable to attend. On the day of the meeting you find that you can attend; you are anxious to do so and to vote your own stock. What arrangements must you make to do so?

b. You are a member of the board of directors of a corporation. This board is to meet on the first Monday of next month. You are compelled to be out of the city at that time and

cannot attend the meeting. How can you arrange to have your vote cast on questions which may arise at the meeting?

3. The Jamestown Manufacturing Company, a corporation, has authorized stock of \$500,000: \$200,000 of it is non-voting preferred and is outstanding; the remaining \$300,000 is voting common stock—\$200,000 outstanding, \$80,000 in the treasury of the company, and \$20,000 unissued. The par value of all the stock is \$100 per share. You own \$50,000 of the preferred stock and \$80,000 of the common stock. Nine directors are to be elected. The cumulative method of voting is used. How many shares, and of what class, will you have to procure in addition to your present holdings to be able to elect five of the directors?

4. With the same facts as in the above problem (No. 3), determine how many directors you can safely attempt to elect with the stock you already hold.

5. You are one of the creditors of a corporation which has just become insolvent. You and the other creditors are convinced that, if foreclosure is not made and if the company is placed under efficient management provided by the creditors, it will recover and will pay the creditors in full. It cannot do this if foreclosure is resorted to at once. Suggest a method by means of which the creditors can procure control for a definite period.

CHAPTER VII

Financing by Means of Stock

The owned capital of the business.—The *owned capital* of a business is that part of its capital which is actually and permanently invested in it by its proprietors, whether they be partners, stockholders, trustors, or what not, with no obligation on the part of the company to return it, except pro rata in the case of dissolution. It is the permanent part of the capital, and in a corporation it is represented by its issued stock. Owned capital is presumed to obligate a company to pay to the investors from time to time, usually at stated intervals, their proportionate shares of any profits available for distribution, but it does not involve the company in any fixed or compulsory obligation to the investors in case such profits are not available.

The financing of joint-stock companies, Massachusetts Trusts, and corporations is accomplished either through the use of funds obtained by the contribution of individuals who buy shares in the enterprise or through the use of borrowed funds. It is the purpose of this chapter to discuss owned capital which is usually referred to as the capital stock of the business.

Capital stock, capital, capitalization.—Before entering any discussion of financing, it is necessary to clarify the meaning of the terms *capital stock*, *capital*, and *capitalization*, with which we immediately come face to face.

Capital stock represents the actual amount of capital stock issued by the company and outstanding, and not necessarily the total amount of authorized stock, much of which may not be issued.

Capital, as explained in Chapter I, consists of all the property of every kind employed in the business: the total ownership, consisting of the amount invested; the surplus; and the

undivided profits. It is also frequently described as the sum of the capital stock and the surplus and undivided profits.

Capitalization is a very freely used word, and everyone accepts it as having to do with the capital, or securities, or value, or size of a corporation; but if we should attempt to pin practically anyone down to a real definition, we should find out then how vague is the impression which the word conveys.

As used in law, *capitalization* means the total par value of the authorized capital stock of a corporation. In the financial and business worlds, however, it is taken to mean one of the following:

1. The par value of all stocks and bonds outstanding at any particular time.
2. The par value of outstanding stocks and bonds, as above, plus the face value of other long-term obligations.

Definition No. 2, above, closely approaches what is generally meant by capitalization, since it represents the funds that the company has actually raised for capital purposes. The trouble comes when we try to define the last part and to say what shall be included in and what excluded from "other long-term obligations." Some will say "all obligations running for twenty years or more"; others will say "those running for ten years or more." Often they may be argued down to an even shorter term, and so the definition may be rendered absurd. It is not uncommon for a company to have borrowed money on a very short term and to have invested it in permanent fixtures, equipment, or other capital goods. There can be no doubt in such a case that the value of the securities given for the loan constitutes a part of the capitalization.

An attempt was made some years ago by Senator Newlands, of Nevada, to put a bill through Congress settling this matter, at least in so far as it affected corporations engaged in interstate commerce. The bill (Senate Bill 2941) provided that the capitalization should be considered to be "the par value of the total securities, including shares of stock and all obligations running for . . . years or more." No agreement was ever reached as to what number should be written

in the significant blank space, and the bill was eventually withdrawn.

It would seem that the test for securities other than stocks and bonds, when one is considering whether or not their value should constitute a part of the capitalization, should be the use to which their proceeds are put rather than the length of life of the obligation. This use, however, would be very difficult—often impossible—of ascertainment and would make an impracticable definition if used.

Pending some accepted standardization of the term, many careful financiers use it only when they can include with it an explanation of their meaning, while others actually avoid its use.

At the initial financing of an enterprise the financial plan provides only for stock, or only for stock and bonds, and practically never for anything else, so that the term may be used without confusion at that time. It is only after the financial affairs of the company have become involved with many kinds of obligations that trouble arises.

All of the above discussion refers to the term *capitalization* when used in the sense of indicating the quantity or the amount of the capitalization of a company. There is another sense, however, which indicates certain action on the part of the company organizers or managers. There is no dispute in regard to the meaning of the word in the latter sense, and its definition can be stated as follows:

Capitalization is the act or process of fixing the value of an enterprise for the purpose of determining the capital liabilities which the company may assume in exchange for the property.

Basis of stock financing.—*Financing by means of stock* is simply arranging to operate a business on permanently owned capital invested by interested parties who, by virtue of their investments, become the owners of the business. *Stock* is merely a name for the aggregate ownership of a corporation. There are, however, in most corporations a large number of investor-owners, and the ownership or stock is therefore divided into a number of units or *shares*, of which each investor or *stockholder* may own one or many.

A share of stock, then, is one of the units of ownership. This ownership is represented by certificates of stock, and when a person buys one or more shares of stock he receives, as evidence of his partial ownership in the corporation, a *certificate of stock* filled out for the proper number of shares.

This is a very convenient and practical method of representing the ownership, because the ownership can readily be transferred by the transfer of the certificate. If a person has a certificate for any number of shares of stock (let us say 50), and wishes to sell a portion of his holdings (let us say 25 shares), he can write out an assignment of 25 shares to the purchaser and send this assignment, together with his certificate for 50 shares, to the transfer agent of the company, who will have the transfer properly made on the books of the company. Two new certificates will then be made out, each for 25 shares and each in the name of the respective owner. The old certificate is canceled and kept on file by the company.

It must be understood that while every corporation must have stock and must do its fundamental financing by means of the owned funds contributed by the stockholders, there is practically no corporation which finances by stock exclusively. Every business finds it necessary to borrow occasionally for short periods, and the great majority of companies find it profitable to utilize long-term borrowed funds represented by bonded indebtedness (See Chapter X).

Features of stock financing.—Financing by stock has many important features affecting both the corporation and the individual stockholders which must be understood by the financier.

From the point of view of the company, stock financing provides a fixed amount of definitely and permanently owned capital which the management can use at its discretion as long as the business exists. There is no worry about having to pay it back to the investors at any future time, and there are no interest charges which have to be met. The entire net income is at the disposal of the management: it may be reinvested in the business, distributed to stockholders as dividends, or put into reserves (See Chapter XV on "Surplus, Dividend. and Reserve Policies").

As for the investor, stock gives him a permanent investment—not one which will be repaid to him at a future time—necessitating the trouble of reinvesting. If, however, the stockholder does not wish to retain his funds permanently in any one particular company, the stock is fully transferable, and he has the right to dispose of it at any time. Concerning the income from the investment, the stockholder shares the fortunes of the company: large earnings ordinarily produce large dividends, while small earnings bring small dividends or perhaps none at all. Stock ownership usually gives the holder a certain amount of control in the business (See Chapter VI), which is greatly desired by many investors.

Dividends.—Owners of stock in a corporation participate in the prosperity of the company by receiving their proportionate share of any profits that the board of directors sees fit from time to time to divide among them. This division of surplus is generally made annually, semi-annually, or quarterly, and all money or other property so divided among the stockholders as profit on their investment is called a *dividend*.

Classes of stock.—Financing by stock requires more than a mere determination to issue and sell stock in a certain amount; it involves a choice among the large number of classes or kinds of stock which have been developed.

From the standpoint of the issuing company, stock must be looked upon as a commodity which it wishes to sell to the public; and like all other commodities, it must be made as attractive as possible to the proposed buyer in order that it may be disposed of easily and at an advantageous price.

Stocks are issued, therefore, in several classes providing numerous combinations of the three elements *income*, *control*, and *risk*. The average buyer of securities wants as large and as steady an income as possible with the smallest risk, and takes comparatively little interest in the control. The cautious investor will take a smaller income if there be less risk attached, whereas the speculatively inclined will take a greater risk by reason of the chance of greater income. Instances often occur where control of the company is the chief end sought by the stock buyer, and he will practically

ignore both present risk and income in order to get the control.

The two most important divisions or classifications of stock are *common* and *preferred*.

Common stock.—*Common stock* is simply ownership in the corporation, carrying with it all the usual rights of stockholders (unless otherwise specified) but no special privileges or preferences.

These fundamental rights of stockholders include the rights—

1. To have proportionate ownership in the undivided assets of the corporation and to hold a certificate stating this ownership in shares.

2. To transfer ownership of shares.

3. To receive dividends when earned and declared by the board of directors.

4. To inspect the corporate books.

5. To subscribe, in proportion to holdings, to any new issue of stock.

6. To have proportionate control through voting power.

7. To vote on other questions affecting the corporation property as a whole.

8. To protect the corporation against the wrongful acts of a majority.

9. To restrain ultra vires acts of the corporation.

10. To share in the proceeds of dissolution.

Preferred stock.—*Preferred stock* is stock which, while it possesses the same rights and privileges as common stock (unless otherwise specified), has in addition certain more or less valuable and desirable preferences. It may be preferred as to assets or as to dividends, or as to both; but in ordinary parlance the term *preferred stock* means preferred as to dividends.

Being *preferred as to assets* means that in case of the dissolution of the company, the holders of the stock will receive their portion of the proceeds of dissolution before holders of other stock, not preferred as to assets, will participate. This preference is, of course, of no service to the stockholder as long as his company is prosperous and in no danger of disso-

lution, but in the case of weak companies the preference tends to give his stock a higher market value than stock not so preferred. And in the case of actual dissolution, where the assets are not sufficient to satisfy all, the preference will prove to be most valuable.

Preferred as to dividends means that this stock is entitled to a specified rate of dividend out of the earnings before any dividend is given to the stock not so preferred. It does not mean that a certain dividend is guaranteed but merely that if any amount of the earnings be declared as a dividend, the amount necessary to pay the specified rate of dividend on the preferred stock (or such part of such dividend as it is possible to pay), must be used for this purpose before any is allocated to pay a dividend on non-preferred stock. If the entire amount declared as a dividend is absorbed by the dividend on the preferred stock, it means simply that the non-preferred or common stock gets nothing. In prosperous companies, however, it is usually possible to pay the stipulated rate to the preferred stock and still have sufficient moneys left to pay an equal or even larger rate to the common stock. It is ordinarily only fair that the common stock should get more, in view of the fact that it takes a risk by permitting the preferred stock to take out its share of dividend first.

It is sometimes deemed advisable to have several issues of preferred stock, one taking precedence over the next, just as ordinary preferred takes precedence over common. These several issues are then usually classified as *1st preferred*, *2nd preferred*, *3rd preferred*, and so on, or sometimes as *preferred A*, *preferred B*, *preferred C*.

These two great classes of stock, common and preferred, have not by any means satisfied the wants of investors and speculators, and hence a large number of variations have grown up, particularly in preferred stock, affecting the income, control, or risk of the stockholders in various manners. The more important of these various classes will be explained.

Non-participating and participating.—*Non-participating preferred stock* is stock which, through the terms of its issue and sale, is to receive a preferential dividend at a stipulated

rate, usually about 6 per cent, and nothing whatever beyond that. All other dividend, regardless of its amount, goes to the common stock.

Participating preferred stock is that which is, first, to receive its preferential dividend at the stipulated rate and, after that, to participate or share with the other stock in the remainder of the funds declared as dividend. This participation or sharing may be done in any one of a number of ways; but regardless of the manner of participation, if the preferred stock shares in any way in the dividend over and above its stipulated rate, it is participating stock.

The methods of participation are generally known as *participating simply*, *participating immediately*, and *participating specially*.

Simple participating.—*Simple or ordinary participation* is an arrangement whereby preferred stock is the first, up to the specified rate, to receive its dividends; after that, common stock will be paid dividends as far as possible up to and including the same rate that the preferred has received; and if, after having paid both the preferred and the common the same rate of dividend, there be anything left of the total amount declared as dividend, it is shared or participated in by both the preferred and common shares alike, just as though they were only one class.

The term *preferred stock* in itself means that it is simply participating.¹ That is to say, if it is intended that the preferred stock should be non-participating or participating in any way other than the ordinary manner described above, it must be definitely so provided in the certificate of incorporation.

Participating immediately.—Preferred stock is said to be *immediately participating* when the arrangement for apportioning the dividend among the classes of stock provides that the preferred stock is the first to receive dividends up to the specified rate and that immediately thereafter, without first giving the common stock a dividend payment at the same rate, all the remainder of the dividend money is allotted to all stock alike, regardless of whether it be preferred or common. This method of participation is not often used,

¹ *Sternbergh v. Brock*, 225 Pa. 279.

and many financiers prefer to regard it as merely one of the *special* methods of participation described in the following paragraph, rather than as a separate type.

Participating specially.—The above-described methods of participation are, however, by no means the only ones. As a matter of fact, the number of methods of participation is limited only by the ingenuity of the company organizers. It is possible, for instance, to have the preferred get 6 per cent, then the common 6 per cent, then the preferred all the remainder; or the preferred 6 per cent, then the common 6 per cent, then the preferred 4 per cent, then the common 2 per cent, then the remainder pro rata; or the preferred 5 per cent, then the common 6 per cent, then the preferred and the common all the remainder in the proportion of two to one; or any other arrangement whatever that may be provided in the certificate of incorporation, which in this respect constitutes a contract between the company and the stockholder.

Any and all methods of participation other than simple participation and immediate participation are generally grouped under the name *special participation*.

Non-cumulative and cumulative.—The dividends on preferred stock may be *non-cumulative* or *cumulative*.

Provision is often made in the certificate of incorporation that if sufficient dividends are not declared in any one year to pay the full dividend on the preferred stock, there is no obligation on the part of the corporation to make up the deficiency in any subsequent year. This means that dividends or parts of dividends not paid to preferred stockholders in any given year are lost to them forever. Stock governed by this provision is known as *non-cumulative*.

For a number of years the courts of States where the question has arisen have not been uniform in agreement on the question as to whether or not the holders of non-cumulative stock were entitled to have profits accumulated to their credit during years when, although the directors did not declare a dividend on the preferred stock, the corporation made a profit. In one leading case,² it was held that, although the preferred stock was clearly of the non-cumulative variety, the dividends accumulated to the extent that they were

² *Bassett v. U. S. Cast Iron Pipe & Foundry Co.*, 75 N. J. Eq. 539 (1900).

earned and must be paid before any disbursement could be made to the common stockholders. Since this decision, however, the Supreme Court of the United States has held that the directors may divert earnings to other corporate purposes; and although this results in the omission of preferred dividends, they do not accumulate.³

Cumulative preferred stock, on the other hand, is stock the stipulated dividend of which, if not paid in full in one or more years, carries over from year to year till fully paid. When dividends have not been declared, or have been declared in amounts insufficient to pay the full specified rate of dividend on this cumulative preferred stock, they are *in arrears*; and as long as they are unpaid they constitute a claim on future earnings which has precedence over any dividend claim of the common stock. In other words, common stockholders are not entitled to receive any dividend so long as the cumulative preferred stock dividends are in arrears.

In case the certificate of incorporation makes no provision concerning whether or not the preferred stock dividend is to be cumulative, it has been held by the courts that the dividend shall be cumulative. That is to say, in order for the preferred stock to be non-cumulative as to dividends, the certificate of incorporation must specially so provide.

A company sometimes provides that its preferred stock shall be non-cumulative for several years, after which it shall become cumulative. This provision relieves the company of the necessity of paying full dividends on the preferred stock during the early years when earnings are expected to be small or of having the dividend accumulate as a charge against future years, and yet assures the stock almost as good selling power as if it had been fully cumulative from the first.

Redeemable stock.—Preferred stock, or certain classes of preferred stock, are occasionally made *redeemable*. This means that the company has the option under the conditions and on the terms specified in the certificate of incorporation, of redeeming or buying back the stock from the stockholders. This redemption right rests, of course, entirely with the company, and stockholders can neither compel nor refuse redemption of their stock. Some advance notice of intended

³ *Barclay v. Wabash Railway*, 280 U. S. 197 (1930).

redemption is usually provided for, and a redemption price is generally set at a premium so as to compensate the holder for the loss of his investment and give him an opportunity to seek a reinvestment of his money without suffering loss of income in the interim. Redemption at a premium is not universal, however; many companies have the redemption price set at par.

If the redeemable stock has the voting power, its redemption has considerable effect upon the control of the company because of the elimination of all the votes represented by it.⁸

Redeemability may have a material effect, also, upon the market price of a stock; the tendency is to keep the market price lower than it otherwise might be. If the stock is redeemable at 110 and has an investment value of 140, a buyer would in all probability refuse to pay this much for it, fearing that the corporation might exercise its redemption privilege and deprive him of his stock at 110. Such action would entail considerable loss for him. If, on the other hand, the investment value is below the redemption price, the redemption feature would ordinarily have no effect on the market, unless it were to make the stock slightly less attractive because of the fact that there is an upper limit to the possible price rise.

Convertible stock.—One or more classes of stock may be made *convertible*; that is, exchangeable at the option of the holder, into some other specified security. Conversion, unlike redemption, is always at the option of the holder. The certificate of incorporation may make certain stipulations or set a certain time limit for the conversion, but within these restrictions the stockholder can demand the conversion at his pleasure. The most usual conversion permitted is from preferred to common stock. Convertible stock of this type is rather popular because it enables the holder to receive preference as to dividends when the earnings are small and there is little left for the common dividends, and yet permits him to trade in his stock for common in case the earnings become large and the common is receiving large returns. Having

⁸ An example is the fight between Harriman and Hill for control of the Northern Pacific in 1901. See G. Pyle's *The Life of James J. Hill*, and J. G. Kennan's *E. H. Harriman*.

once converted, of course, he cannot reconvert to what he had before.

The matter of control, also, frequently enters into consideration, as non-voting preferred stock is often convertible into voting common stock. This feature will sometimes induce stockholders to convert, even at a financial loss.

Occasionally stock is issued which is convertible into bonds. This is rare, however, and is hedged about with various protective stipulations. In the first place, such conversion should be made only with the consent of the company, for if this were not the case, holders of such stock in a weak or insolvent company could convert their stock into bonds and thus share in the proceeds of dissolution ahead of many creditors and on an equal footing with other bondholders of the company who acquired them through bona fide purchase. Such a practice would be manifestly unfair. The money which stockholders pay into the company for their ownership is a part of the owned capital of the company, and it is upon the strength of this owned capital and the security afforded by it that the company is enabled to obtain its borrowed capital through the sale of bonds. If, therefore, a large number of stockholders are permitted to convert their stock into bonds, thus becoming creditors of the company instead of part owners, it naturally means an increase of bonded debt with no increase whatever of assets, and lessens the value of all other bonds.

Even should this conversion be left solely to the option of the company, its exercise is permissible only to the extent of the surplus and undivided profits, in order that the amount paid in by these stockholders may remain intact.

Protected preferred stock.—Recently some companies have been making some of their preferred stock especially attractive as an investment by *protecting the dividend*. This means simply that after the preferred dividend is paid, a certain amount is placed each year in a *reserve* or *sinking fund*, before the dividend is paid to the common stock. This sinking fund is built up to some required size and is to be used to pay the preferred dividends in case of poor years, when the current surplus would not be sufficient. When this fund reaches the stipulated size, it is not built up further; the

dividends can then go direct to the common stock, and the fund payment does not need to come in ahead of their payment. If the fund is depleted, however, by being drawn on to meet a preferred dividend in a poor year, it must be built up to full requirements again as before.

Founder's, promoter's, and manager's shares.—These terms mean practically the same thing and are applied to stock of a special type sometimes given to a founder or a promoter for his services in organizing a company, or to a manager for his services in conducting the business. This stock is distinct from common stock and often is so arranged that it will receive a special dividend only after the company has attained a certain degree of prosperity or has paid certain specified dividends on all other stock. It is, thus, a *deferred stock*. Such a type of stock is used much more in England than in America. In America the term *founder's share* is practically synonymous with *promoter's share*; *manager's share* is used in both countries.

Deferred stock.—This is a stock the dividend of which is not to be paid until after the expiration of some given time or until after the happening of some particular event. It is quite common in England and follows the ordinary (common) stock just as the ordinary (common) follows the preferred. In many cases it is sold to the public; in other cases it is used as founder's, promoter's, or manager's stock, as described above.

Debenture stock.—This term is very rarely used in the United States. It is an English expression meaning, in reality, not stock at all but a bond, corresponding to our debenture bond. In American finance, however, the name has been adopted by a few corporations and applies to a special type of stock which confers rights that are superior to both preferred and common. The stock is similar in nature to a prior-preference stock. An excellent example of this use of the term is the 7% debenture stock of the Bush Terminal Company.

Prior preference stock.—*Prior preference stock*, or *prior lien stock*, is a term rarely used; it indicates usually that, after the issuance of the regular preferred stock, another issue has been issued with the consent of the old stockhold-

ers, having a claim prior to that of all other stocks on dividends or assets. Upon issue it becomes a *first preferred stock*, and the other names serve merely as convenient descriptions. The prior preferred stock of the Consolidated Cigar Corporation and the preferred stock of the Market Street Railway Company of San Francisco are examples.

Guaranteed stock.—*Guaranteed stock* is stock the dividend payments of which are guaranteed by some other company, usually one that is using the property of the issuing concern. Railway companies frequently lease and operate the property of other companies, and, as part of the rental, they guarantee the payment of dividends at a certain rate to all the stockholders. Although such operation is more general among railway companies, it is also frequently practiced among industrials. Preferred stock is sometimes referred to as *guaranteed stock*, a term which, of course, is erroneous. A corporation cannot guarantee its own stock and cannot issue guaranteed stock.

Voting and non-voting stock.—All stockholders have the inherent right to participate in the management of the corporation through voting for directors and on other matters. Non-voting stock may be issued, however, and purchasers of such stock voluntarily surrender their voting rights. It is generally customary to give the vote to the common stock and to withhold it from the preferred. The vote may be apportioned among several classes of stock in any desired manner, as long as at least one class of stock is vested with voting power. If stock is issued as voting stock, however, such stock cannot be deprived of its vote without the consent of the holder.

Vetoing stock.—*Vetoing* is the name given to stock which does not have general voting power but which is entitled, through provision of the certificate of incorporation, to vote on certain questions. Thus a certain issue of preferred stock may be voteless except on the question of the issue of additional preferred stock; on this question it is given the voting right.

It is quite common to give to non-voting preferred stock the right to vote after its dividends have not been paid for a certain number of years, and to continue this voting power as

long as the dividends are unpaid or, in case of cumulative preferred stock, as long as the dividends are in arrears. In such cases this stock is given sometimes the right to vote along with the common, sometimes the exclusive voting right, and sometimes the right to elect the majority of the board of directors.

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Questions for Study and Review

1. *a.* Define and explain the terms *capital stock* and *capital*.
b. Discuss in detail the term *capitalization*.
2. Differentiate between owned capital and borrowed capital.
3. Why is stock divided into classes, and what are the characteristics which distinguish the two main divisions?
4. What are the fundamental rights of a stockholder in a corporation?
5. What is the difference between the terms *preferred as to dividends* and *preferred as to assets*?
6. Name and explain the several kinds of stock participation in dividends.
7. What is cumulative stock, and what is meant when one says that dividends are in arrears? Explain.
8. *a.* What is redeemable stock? At whose option is the redemption? How does the redemption feature affect the market price?
b. May the control of a corporation ever be affected by the redemption of stock?
9. *a.* What is convertible stock? Is convertibility a desirable feature for the stockholder? Why?
b. May the control of a corporation ever be affected by the conversion of stock? Explain.
10. Compare and differentiate between cumulative preferred stock and protected preferred stock.
11. Explain what is meant by managers' shares; deferred stock.
12. Why do old stockholders have to consent before preference stock may be issued?
13. Differentiate carefully among voting stock, non-voting stock, and vetoing stock.

Problems

1. The certificate of incorporation of Company A authorizes 500 shares of preferred stock, and 1,000 shares of common stock, each of \$100 par value. The company has sold at par and issued 450 shares of preferred stock and 800 shares of common stock. It has sold and issued at face value (\$1,000 each) 50 twenty-year, six per cent first mortgage bonds; and has borrowed from the president of the company \$2,000 on a two year note to take advantage of a quick buy in raw material. It has procured from its local bank \$6,000 on 50-day notes to pay current bills and take advantage of the cash discount. Its books at the present time show surplus and undivided profits of \$22,000.

What is the company's capital stock; its capital; and its capitalization?

2. The Modern Printing Company, a corporation, has outstanding \$25,000 in 5 per cent preferred stock, and \$25,000 in common stock. All shares have \$100 par value. In 1935, it distributed as a dividend the sum of \$1,250. In 1936, it distributed as a dividend the sum of \$2,500. In 1937, it distributed as a dividend the sum of \$5,000. How would these sums have been divided between the two classes of stock in the respective years, provided:

- a. That the preferred was non-participating?
- b. That the preferred was participating simply?
- c. That the preferred was participating immediately?

3. A corporation has outstanding \$3,000,000 worth of common stock and \$2,000,000 worth of 5 per cent preferred stock; all of the stock is composed of \$100 par value shares. The corporation declares a dividend of \$1,000,000. How much money will go to the preferred, and how much to the common, in each of the following cases; what rate of dividend will each class of stock receive in each case:

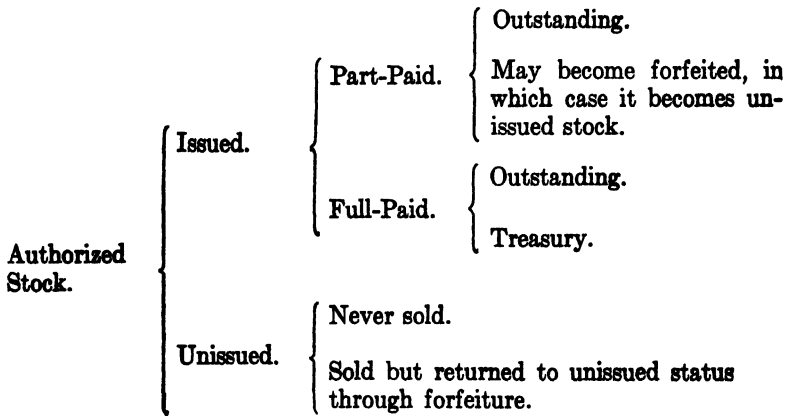
- a. If the preferred is non-participating?
- b. If the preferred is participating simply?
- c. If the preferred is participating immediately?
- d. If the preferred is cumulative, non-participating, and has not received dividends for the past two years?
- e. If the preferred is cumulative, participating simply, and has not received dividends for the past two years?
- f. If the preferred is cumulative, participating immediately, and has not received dividends for the past two years?

CHAPTER VIII

Financing by Means of Stock (*Continued*)

Names defining stock status.—Besides the names given to the various classes of stock to indicate the rights and privileges which they convey to their owners, there is another series of names used. Each of these terms is applicable to any class of stock and is intended to show the status of the ownership of the shares.

These terms may be diagrammed as follows:



A brief explanation of these terms will be helpful.

Authorized stock.—*Authorized stock* is the total stock of all classes which the corporation is authorized to issue according to its charter or certificate of incorporation. Regardless of what stock is sold and what is unsold, or regardless of the price charged for it and the amount received for it, the total quantity of authorized stock remains the same. The amount of authorized stock can be neither increased nor diminished except by amendment to the certificate of incorporation.

Issued stock.—*Issued stock* is that part of the authorized stock which is issued or sold by the company. It may be issued or sold for cash, property, or services, and may at a given time be held by an outside individual or another company, or may be in the treasury of the issuing company. In any case, it constitutes issued stock.

Unissued stock.—A corporation is not required to issue all of its authorized stock and often does not do so. The difference, then, between the authorized stock and the issued stock constitutes the *unissued stock*.

Full-paid stock.—*Full-paid stock* is stock which has been issued by the company and paid for either in cash, property, or services up to its full par value; or, in the case of stock without par value, it is that stock which has been paid up to the full amount set by lawful methods as the price of the stock. Full-paid stock carries no liability to creditors except in banking corporations, where there is double liability on the part of the stockholders. It may at any given time be either outstanding stock or treasury stock, two terms which are discussed below.

Part-paid stock.—Corporations are not permitted by the statutes of most states to issue or sell their stock at less than its par value, but they may sell it on a partial payment or installment plan, by which the purchaser pays a stipulated sum at the time of sale and obligates himself to pay other sums from time to time as the directors may *call* for them, until the full par value has been paid. Stock which has been thus purchased but which has not as yet been paid for up to its full par value is known as *part-paid stock*. When stock is sold on the part-paid plan, it is quite common for the company to keep possession of the certificate until complete payment up to par value has been made, though some follow the practice of issuing the certificate at once and marking it "Part-Paid."

Outstanding stock.—*Outstanding stock* is the issued stock, either full-paid or part-paid, owned or held by any parties outside of the issuing company itself. It is, in fact, all of the issued stock except that which may be held by the company as treasury stock.

Treasury stock.—*Treasury stock* is a corporation's own

stock, which has been issued and reacquired by purchase, donation or otherwise. It must in every case be full-paid stock; otherwise it cannot be accepted and held as treasury stock. While held as treasury stock, it does not vote or draw dividends. It can be sold by the company below par, if desired, because the company has already received full par value for it. In case of sale, it again becomes, of course, outstanding stock and regains whatever dividend and voting rights it originally had. While held in the treasury, it constitutes an asset of the company, and on the balance sheet may appear on the asset side; but it is considered preferable to show it as a deduction from stock issued and outstanding.

Unissued stock is frequently called treasury stock, but this name is entirely erroneous. The latter differs very definitely from the former in that it has been issued, is fully paid, and can be sold below par value.

Forfeited stock.—When a person holding part-paid stock, on which installments of the unpaid portions up to par value are callable, fails to meet any specified call of the directors, his stock is forfeited to the corporation and reverts to the status of unissued stock.

There are several ways in which the company may handle the forfeited stock. It may resell it to the highest bidder as part-paid stock. If the selling price is no greater than the amount of the delinquent installment, the original purchaser loses by forfeiture his entire deposit; but if it is in excess of the delinquent installment, the original purchaser is given the excess up to the amount of his original deposit. It may be resold as full-paid stock; in this case the portion of the selling price necessary to bring the total already received by the company on the stock up to par is retained by the company, and the balance, if any, less the expenses of the sale, is turned over to the original holder. The law of New York, and of some other states, provides that upon default in the payment of a call upon part-paid stock, the board of directors, after sixty days' notice to the defaulting stockholder, may declare forfeited not only the stock, but also all previous payments made thereon (S. C. L., Sec. 68). Then the corporation may, if it wishes, resell or reissue the forfeited stock without payment of any kind to the defaulting holder.

Creation of full-paid stock.—Sometimes it is considered desirable for a corporation to sell certain of its par value stock at a price below par value, or to have a certain amount of a particular class of stock which it can offer as a bonus with the purchase of other shares at the full price. In order to accomplish this, it is necessary to create some full-paid stock, which, of course, being fully paid to par, can be sold by the company at any price or actually given away as a bonus, without violating the law and without subjecting the holder to any liability to creditors of the company.

In most states a corporation may accept as payment for its stock either cash, services, or property. Therefore, a quantity of stock may be issued for a patent, for real estate, for goodwill, for another property, or for the services of a promoter or organizer; this property or service is valued at the par value of the stock thus issued. Such stock becomes full-paid outstanding stock. The recipient of this stock can then donate a part of it back to the company, thus creating full-paid treasury stock which the company can sell below par or give out as a bonus.

Some states are very strict in demanding and seeing that the property or service given in payment for stock is not overvalued. The New York statutes are quite liberal in this matter, providing (S. C. L., Sec. 69) that, in the absence of fraud in such a transaction, the judgment of the directors as to the value of the property shall be conclusive.

It must not be understood from the fact that a seller of property accepts stock in payment and then donates a part of it back to the company, that his property has necessarily been overvalued or that the transaction is fraudulent. Let us take as an example a man with a valuable patent to be exploited or a tract of land to be developed. This man, however, has no money or capital and probably no ability to carry on the necessary exploitation or development; hence, he can get absolutely nothing out of his holdings. A certain corporation estimates that the patent or land is worth to it \$1,000,000. The corporation may offer the owner \$600,000 in its stock for his property, which we shall presume he is glad to take. Instead of giving him the \$600,000 in stock, however, they agree to give him \$1,000,000 worth

(the value of his property to the corporation), with the understanding that he will return \$400,000 worth to the treasury. The entire \$1,000,000 worth of stock becomes full-paid, and the company has \$400,000 worth which it can dispose of on any terms it may wish. The property has not been overvalued because it is really worth \$1,000,000 to the company or to anyone in a position to exploit or develop it. Today there is no particular virtue attaching to the issuance of stock with a par value of \$100. Corporations freely issue stock with no par value as discussed below or stock having par value as low as \$1 per share.

✓ **No-par value stock.**—It has been seen from the foregoing discussion that the use of stock with a par value may cause some embarrassment in the starting of a business and even in subsequent financing. In 1912, New York State authorized the use of so-called non-par or no-par value shares. Since that time, the use of no-par shares has so increased in popularity that it is quite probable that two-thirds of all of the common stocks outstanding and at least one-third of the preferred stocks are no-par. No-par stock may be issued with a stated value representing the minimum which may be accepted by the corporation in payment for this stock. The certificate of incorporation or the by-laws establish the stated value. It is also issued with no designation of value in any form.

It has been pointed out by many financial writers that one of the chief advantages of no-par stock is to do away with subterfuges and fictitious values. It was felt that the absence of a printed par value upon the stockholder's certificate would make him realize that his share did not represent any specific amount but rather a proportionate equity in the assets of his corporation. All no-par value shares sold in accordance with the statutes of the state and the provisions of the certificate of incorporation are deemed fully paid and non-assessable, and the holder of such shares is not liable to the corporation or the creditor in respect thereto. Every certificate of stock without par value must show the total number of such shares authorized, as well as the number represented by the certificate, and also the authorized number of par value shares, if any, and their par value; this

practice makes it possible to determine the proportionate interest in the net assets of a corporation which a given stock certificate represents. Having no par value or base on which to estimate a percentage dividend, the total dividend allotment is divided equally among all the non-par value shares outstanding and declared as so many dollars per share. (For N. Y. statutes on non-par value stock, see S. C. L., Sec. 12.)

Negotiability of certificates of stock.—Ownership in corporations, as represented by certificates of stock, is made more liquid, more easily transferable, and hence more generally desirable, by reason of the fact that modern legislation makes such a certificate *negotiable* by indorsement. That is, upon indorsement of the certificate by the owner, it can be transferred from one person to another; and the transferee, if he be an innocent purchaser for value, will have absolute and sound title to the stock represented by the certificate, regardless of whether the title of the transferor was good or not. He does not purchase merely as good a title as the previous holder had, as would be the case with non-negotiable property. Thus title to these negotiable certificates of ownership may pass through the hands of a finder or thief to an innocent purchaser for value.

If a certificate be lost or stolen, the owner should immediately notify the transfer agent of the company. If it is not found, the company will issue the owner a duplicate upon his putting up a bond to indemnify the company in case the original certificate shows up in the hands of an honest purchaser. In each state the negotiability of stock certificates dates from the passage of the legislation so affecting them. In New York, the Uniform Stock Transfer Law, under which stock certificates are made negotiable, was enacted September 1, 1913, and all certificates issued in this state prior to that date remain non-negotiable.

The New Jersey Uniform Stock Transfer Act went into effect March 18, 1916.

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Questions for Study and Review

1. What designations are given to stock to indicate the status of its ownership? Define each.
2. Distinguish between *treasury stock* and *unissued stock*.
3. In what ways may a corporation handle forfeited stock and previous payments thereon?
4. What may a corporation accept as payment for its stock?
5. What is non-par value stock?
6. How are dividends declared and paid upon non-par value stock? Why are they declared in this manner?
7. Explain the meaning of negotiability.
8. Are certificates of stock negotiable? Give the name and date of the New York State statute on this matter.

Problems

1. The following statements represent the eight successive steps in the raising of capital for a corporation by the sale of stock:

- (1) The National Hat Manufacturing Corporation is organized with authorization for \$500,000 worth of stock of a par value of \$100.
- (2) The company sells and issues \$50,000 of its stock at par to each of the following: Mr. Anson, Mr. Buckley, Mr. Clay, Mr. Damon, and Mr. Elton. Each pays in 10 per cent on his purchase.
- (3) The company makes a call of 10 per cent on all of its outstanding stock, and all the holders pay.
- (4) Mr. Foster sells a patent to the company for \$40,000 and takes payment in stock.
- (5) The company makes another call of 10 per cent on its part-paid stock, and Mr. Buckley does not meet it. Failure to do so causes his stock to be forfeited.
- (6) Mr. Foster donates \$10,000 of his stock to the company.
- (7) The company sells \$20,000 of its stock to Mr. Green at par for cash.
- (8) The company then sells all the stock it has, both unissued and treasury, to Mr. Haskins, at the lowest figure it can without subjecting him to any future liability upon it.

With these facts before you, work out the following questions:

a. Prepare a tabular statement showing the amount of authorized, issued, unissued, outstanding, treasury, part-paid, full-paid, and forfeited stock after the consummation of each of the eight steps.

b. How much, and what kinds of, stock did the company sell to Mr. Haskins in the eighth step; what price did he pay for the stock?

2. Following change of its common stock from par to no-par value, the American Locomotive Company sold Mr. Anderson fifty shares for \$2,500. Explain Mr. Anderson's liability on the stock.

3. *a.* Mr. Alton was the owner of a certificate for 50 shares of stock in the Eastern Shipping Company, a New York corporation, bearing date of July 17, 1918. Wishing to dispose of this certificate, he endorsed it in blank, but then lost it. It was found by Mr. Baker, who sold it to his friend Mr. Clement, who knew it to be a lost certificate found by Mr. Baker. Later Mr. Clement gave the certificate to Mr. Davis as a present, and Mr. Davis accepted it in good faith, not knowing that it was a lost certificate. The following month Mr. Davis sold it to Mr. Emmitt, who, like Mr. Davis, knew nothing of its history. Mr. Emmitt later sold the certificate to Mr. Fischer, who knew the whole story of the certificate. In the case of each man, tell whether or not he got title to the certificate, and why.

b. Assume all the conditions in part *a* of this problem to hold except that the certificate was dated January 2, 1911. Taking each man in turn, tell whether or not he would get title, and why.

CHAPTER IX

Financing with Borrowed Capital

Borrowed capital.—Almost all businesses today borrow a considerable portion of the capital with which they do business. If the loan is desired for a long period, it is customary to issue bonds; if for a short time, notes are generally used. Commercial paper, meaning notes of large denomination sold through brokers to banks, is often used for large loans of short duration. For temporary working capital needs, funds are generally borrowed from banks on an open line of credit. Thus, *borrowed capital* may be for either long-term or short-term purposes, but is never permanent capital as is that owned by the company. It likewise places upon the company fixed or obligatory charges for the interest at stated periods and for payment of the principal at the maturity of the loan. The details of borrowed capital of various kinds will be treated at length in future chapters. Let us at present determine the reasons for borrowing in the financing of a business.

Business borrowing.—Modern business methods have changed the act of borrowing for business purposes from an indication of weakness and improvidence to an evidence of business strength and acumen.

In former times business men borrowed only in case of financial necessity, and those who never had to borrow prided themselves on the fact and were held up as proper examples of business success. When a man sought a loan, he became an object of considerable suspicion to his banker, his creditors, and his fellow merchants or manufacturers. The general opinion was that he must be very hard pressed or he would not have to borrow. Often when borrowed capital could have been used to great advantage, it was not made use of because of the danger to the credit and repu-

tation of the business caused by its becoming known that the business was borrowing money. When money was borrowed, every effort was made to keep the transaction an absolute secret. These conditions do not exist today, except in some individual cases where attendant circumstances are suspicious, or in small and circumscribed communities. The business loan of today is very seldom an emergency measure to bolster up a weak business. Generally, it is part of a well-prepared plan to give additional strength to a strong enterprise. As a matter of fact, a business which is in poor condition and in dire need of money will find it almost impossible to procure a loan under any conditions, while the prosperous businesses have money thrust upon them.

The inexperienced will ask, "If a business is prosperous and not in need of money for some emergency, why borrow?" The answer is that the object of borrowing today is to supply additional capital upon which the business can make a profit without either asking the owners for additional investment or selling an interest to outsiders, thus increasing the number of persons among whom the profit must be divided. Generally speaking, the more prosperous a business is, the more advantageously it can use borrowed capital.

Trading on the equity.—Suppose a certain business has a capital of \$100,000, and is quite prosperous, earning a net income of 20 per cent¹ on this capital. If the prosperity is not merely a temporary condition, but extends back over considerable time (and all indications are that it will continue), then the owners of the business might well say, "Why be satisfied with \$20,000 net income per year? Our business is well established, and careful analysis and study show that with larger capital we could do a proportionately larger business—that we could, in short, make 20 per cent net income on \$150,000 as surely as upon \$100,000. Why not increase our capital and earn the extra income?"

Granting that all the conditions are as represented, it

¹This case is somewhat exaggerated, as there are very few businesses capable of earning a net profit of 20 per cent on their capital, but the exaggeration is intended to bring out the idea and the point involved more clearly.

would, of course, be perfectly good business policy to enlarge the business and enjoy the larger income. Then comes the question of how to raise the funds for the increase of capital. As is always the case, there are only two methods available: selling an interest in the ownership of the business, and borrowing money. Selling an interest in the ownership would mean either that the present owners would have to put up additional capital and virtually buy the new interest themselves, or that they would have to take in new associates and thus increase the number of owners among whom the profits must be divided. The former plan would mean that the present owners, though drawing larger incomes each year, would be receiving no higher rate on their enlarged investment than they are now receiving on their present one. The latter would mean that the present owners would be getting neither a larger amount nor a higher rate than at present, but merely that they had let some other party or parties in on their good proposition. There is really no special reason for doing such a thing. If, of course, it can be shown that the increase of capital will enable the business to earn a higher rate than before, so that the income of the original amount invested would be greater, then this taking in of new owners is more justifiable.

Let us consider the proposition of borrowing \$50,000 to increase the business capital. In this case, the old owners are not called upon for any additional investment, nor is there taking in of new owners necessitating a wider division of the profits. If the money can be borrowed at a normal interest rate, say 6 per cent, a fixed interest charge of \$3,000 per year will be placed upon the business. But the \$50,000 additional capital in this business should earn profits at the rate of 20 per cent, or an amount of \$10,000. After paying the interest charge of \$3,000 out of this \$10,000 profit, there is left for the owners of the business the sum of \$7,000, which has been earned clean and clear for them by the borrowed money and without any additional investment whatever on their part. Their own investment of \$100,000 has earned \$20,000; and if we add to this the \$7,000 earned on the borrowed capital, we have a net profit to the owners of

\$27,000, or 27 per cent on the actual amount they themselves have invested.

Of course, the lender of the additional capital has a claim of \$50,000 against this business, and the owners cannot be said to own it all until they have paid back the loan. Their actual ownership in the business is in the amount by which the total value exceeds the loans (in this case, presumably \$100,000), and this is called their *equity*. The owners have an equity in the business rather than actual complete ownership; hence, doing business on partly borrowed capital which has a prior claim on earnings and assets is known as trading on the equity.

Effect of trading on the equity.—Trading on the equity, or using borrowed capital in a business, is profitable as long as the borrowed capital can be made to pay the business more than it costs, but naturally it becomes a source of decrease in profit rates when it costs more than it earns. This gives rise to the easily remembered expression, “Trading on the equity magnifies both profits and losses.”

To make clear how this occurs, let us presume that Mr. A and Mr. B are respectively the proprietors of two similar businesses having the same earning power and expense ratio. Mr. A is doing business on a capital of \$250,000, which is all his own, while Mr. B is doing business on a capital of \$375,000, of which \$250,000 is his own and \$125,000 is borrowed money. Each business has a normal yearly gross income equal to 20 per cent of its capital, and normal annual operating expenses equal to 60 per cent of its gross income. Assume that Mr. B is paying interest at the rate of 6 per cent on his borrowed capital.

The following schedule will show the variation of the returns on the owner's investment in each of these businesses for a normal year, for an especially good year, and for a poor year.

The figuring of the operating expenses for the good and for the poor years in this schedule is based on the assumption that in each of these two businesses 60 per cent of the normal operating expenses remains stationary, while 40 per cent fluctuates in proportion to the increase or decrease of the gross income.

SCHEDULE

	<i>Mr. A's Business</i> <i>Owned Capital \$250,000</i>			<i>Mr. B's Business</i> <i>Owned Capital \$250,000</i> <i>Borrowed Capital, \$125,000</i>		
	Normal Year	Big Year	Poor Year	Normal Year	Big Year	Poor Year
Gross Income...	\$50,000	\$65,000	\$35,000	\$75,000	\$97,500	\$52,500
Operating Ex- penses.....	30,000	33,600	26,400	45,000	50,400	39,600
Net Income...	\$20,000	\$31,400	\$ 8,600	\$30,000	\$47,100	\$12,900
Fixed Charges..	7,500	7,500	7,500
Return on Own- er's Investment	\$20,000	\$31,400	\$ 8,600	\$22,500	\$39,600	\$ 5,400
Rate of Return on Owner's In- vestment.....	8%	12.56%	3.44%	9%	15.84%	2.16%

Here it can be seen that the person trading on the equity has, even after paying the interest charges on the borrowed capital, increased his rate of profit in the normal year, increased it still more in an especially good year, but has had it considerably reduced during a poor year.

It is, therefore, easy to understand that while borrowing capital may be a good policy for a business with a stable income, it is an improper and often dangerous one for a company whose income is fluctuating; for, in a poor year not only may the net profit be cut to zero by the operating expenses plus the interest charges, but in many cases there may not even be funds available for meeting the interest charges.

It is a recognized financial axiom that, in similar businesses, the more stable the income, the more capital the business can safely borrow.

Secured and unsecured loans.—Doing business on partly borrowed capital takes away from corporate directors, to some extent, their absolute independence of action, for it involves a lender as well as a borrower, and the lender's demands are frequently the determining factor in settling the conditions of a loan.

Money in comparatively small amounts can often be borrowed without security; the borrower simply gives some kind of acknowledgment of the debt, or possibly a simple note promising to repay it at a certain time. Such loans are usually obtained from personal friends of the proprietors, or from the proprietors themselves, but they are seldom for long periods.

Loans of this type, however, form only a part of the borrowed capital used in business. Suppliers of long term capital often demand security as assurance that loans will be repaid as agreed. This is evidenced by the general superiority of mortgage over debenture bonds as an investment medium. This security normally takes the form of a lien upon some property of the borrower. This means, in effect, that if the loan is not repaid in the manner and at the time agreed upon, the lender will have a direct claim, up to the amount of his loan and interest, upon the property of the borrower on which the lien is placed, and usually he may sell this property and repay himself out of the proceeds. Any remainder, of course, goes to the borrower.

If the property has sufficient value, it is possible to obtain several successive loans upon it that are known as the *first, second, third, fourth*, and so on, *liens*. These successive liens take precedence one over another, in the order of their making. The terms *senior* and *junior lien* are frequently used. The lien having first claim on a property is senior to all others, and the one having the last claim is junior to all others; while any intermediate lien is junior to all having claim ahead of it and senior to all having claim subsequent to it.

Prior lien means a lien placed upon property and taking precedence over one or more liens already upon it. It may be, and usually is, prior to all other liens, but it may by arrangement be made prior only to the second and subsequent liens, the third and subsequent liens; or, in fact, it may be inserted at any place in the line of liens. Of course, a prior lien can be placed upon the property only with the consent of all the creditors whose claims it is to precede.

There are certain liens upon real property known as *statutory liens*, which are not brought about by loans. The

principal of these is the *lien for taxes*. The laws of most states provide that taxes on land shall constitute a lien thereon and that, if these taxes are not paid, the property can be sold and the proceeds of the sale applied to the payment of the taxes. The lien for taxes takes precedence over all other liens.

Security and equity.—The security back of a first lien is the actual property upon which the lien is placed, but in dollars and cents it is the actual price which this property brings over and above the costs of selling when it is sold to satisfy the lien. This amount can, of course, be estimated only when the loan is made and the lien placed. The security back of a second lien is what is left of the selling price after the selling expenses and the full claim of the first lien have been paid. Likewise, the security back of each junior lien is what is left of the selling price after the selling expenses have been paid and all senior liens satisfied.

Any amount remaining after the selling expenses and all the liens have been paid belongs to the borrower, the former owner of the property, and is known as the *owner's equity*. While the loans and liens are actually standing upon the property, the owner possesses his equity in it, but its amount and value are only an estimation, as the property may sell for either more or less than contemplated.

The owner's equity, after the first lien, becomes the security for the second lien, and so on, since the equity after each lien becomes the security for the succeeding one. Thus:

\$100,000	Value of property, security of 1st lien.
50,000	Amount of loan secured by 1st lien.
\$ 50,000	Owner's equity, and security of 2nd lien.
15,000	Amount of loan secured by 2nd lien.
\$ 35,000	Owner's equity and security of 3rd lien.
10,000	Amount of loan secured by 3rd lien.
\$ 25,000	Owner's equity after 1st, 2nd, and 3rd liens.

When property securing several successive liens is sold to satisfy them, the senior lien is (after the payment of the taxes and the expenses of foreclosure and sale) entitled to complete satisfaction before the junior lien receives anything. Likewise, each lien in succession must be satisfied

in full before the next participates. Since sales to satisfy liens are generally brought about by insolvency of the debtor, there is often not enough left to satisfy more than the first or second lien. The question of precedence and participation of liens will be discussed in more detail in the following study of mortgages.

The mortgage.—There are several kinds of liens upon property: the *statutory lien*, spoken of above; the *common-law lien*, the right to retain possession of property until the debt or charge of the possessor is satisfied—such as, the right of a garage man to hold an automobile until he has been paid for the repairs, or of a hotelkeeper to hold the baggage of a guest until his bill has been paid; the *equitable lien*, one recognized only in equity; and the lien *created by a mortgage*. It is about the last-named class of liens that we speak in business finance.

When a person or firm borrows money and the lender demands security, it is customary to give the latter a mortgage on certain property, which creates a lien on that property for the benefit of the lender. The lien may be described as “a legal claim or hold on property as security for debt or charge,” under which claim or hold the property may eventually be sold upon the instance of the holder of the lien to satisfy his debt. The modern mortgage takes the form of a deed to the property. One might presume that this form conveys title to the creditor, but it does not, since it contains a *defeasance clause* providing that the conveyance of title is void if the debtor discharges his debt at the time and in the manner agreed upon, and it also contains certain covenants protecting the creditor while the debtor is in possession of the property.

There are two parties to the agreement:

First, the *mortgagor*—owner of the property to be mortgaged, borrower of the money or owner of the debt, and giver of the mortgage.

Second, the *mortgagee*—lender of the money or holder of the claim, and acceptor of the mortgage.

These two parties may write into the mortgage agreement any mutually satisfactory provision which the law permits.

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To facilitate the study of the *corporate mortgage*, it is probably well first to take up the simple *real estate mortgage*, of which the following is a typical form with the several clauses indicated and named.

REAL ESTATE MORTGAGE

Parties.

THIS INDENTURE, made this 15th day of October, 1931, between William H. Bowen (unmarried), party of the first part, and hereafter designated the mortgagor, and Henry A. White, party of the second part, hereinafter designated the mortgagee.

Preamble or recital.

WHEREAS, the said mortgagor is, by virtue of a bond bearing even date herewith, justly indebted to the said mortgagee in the sum of \$5,000 lawful money of the United States, secured to be paid on the 15th day of October, 1936, together with interest thereon to be computed from the 15th day of October, 1931, at the rate of 6 per cent per annum, and to be paid on the 15th day of April next ensuing the date hereof and semi-annually thereafter.

Granting clause, including consideration. Note that the true consideration is contained in the recital.

NOW THIS INDENTURE WITNESSETH, that the mortgagor, for the better securing the payment of the said sum of money mentioned in the said bond or obligation, with interest thereon, and also for and in consideration of the sum of ONE DOLLAR, to the mortgagor in hand paid by the mortgagee, the receipt whereof is hereby acknowledged, does hereby grant and release unto the mortgagee, and to his heirs and assigns forever, ALL that certain lot, piece, or parcel of land, with all the buildings and improvements thereon made or erected, situate, lying and being in the Borough of Manhattan, City, County, and State of New York, bounded and described as follows, to wit:

Description of the property mortgaged.

BEGINNING at a certain point on the east side of Adams Street, distance two hundred feet south of the point known as the northeast corner of Adams and Maple Streets, formed by the intersection of Adams and Maple Streets, running thence (1) fifty feet due south on a line with the said Adams Street; thence (2) one hundred feet due east on a line parallel with said Maple Street; thence (3) fifty feet due north on a line parallel with said Adams Street; thence (4) one hundred feet due west on a line parallel with said Maple Street to the place of beginning.

TOGETHER with all fixtures and articles attached to or used in connection with said premises, all of which are declared to be covered by this mortgage, together with the appurtenances, and all the estate and rights of the party of the first part in and to said premises.

TO HAVE AND TO HOLD the above granted premises unto the said mortgagee, his heirs and assigns forever.

Habendum clause.

PROVIDED ALWAYS that if the said mortgagor, or the heirs, executors, administrators, or the personal representatives, successors or assigns of the said mortgagor, pay the said sum of money mentioned in the said bond of obligation, and the interest thereon, at the time and in the manner mentioned in the said bond or obligation, then these presents and the estate hereby granted, shall cease, determine and be void.

Defeasance clause. States conditions under which conveyance granted in former paragraphs will be defeated.

AND the said mortgagor covenants with the mortgagee as follows:

Covenants.

FIRST—That the mortgagor will pay the indebtedness as hereinbefore provided, and, if default be made in the payment of any part thereof, the mortgagee shall have power to sell the premises herein described according to law. Said premises may be sold in one parcel, any provision of the law to the contrary notwithstanding.

Covenant conferring right to sell.

SECOND—That the mortgagor will keep the buildings on the said premises insured against loss by fire for the benefit of the mortgagee. And should the mortgagee, by reason of any such insurance against loss by fire, as aforesaid, receive any sum or sums of money for any damage by fire to the said building or buildings, such amount may be retained and applied by said mortgagee toward payment of the amount hereby secured, or the same may be paid over either wholly or in part to the said mortgagor, or the heirs, successors or assigns of the mortgagor, to enable said mortgagor to repair said buildings or to erect new buildings in their place or for any other purpose or object satisfactory to the said mortgagee, without affecting the lien of this mortgage for the full amount secured hereby before such damage by fire, or such payment ever took place.

Covenant to insure and repair.

THIRD—And it is hereby expressly agreed that the whole of said principal sum, or so much thereof as may remain unpaid, shall become due at the option of

Interest and tax clause. May accelerate the maturity.

the mortgagee after default in the payment of any tax, assessment, or water rate for sixty days after notice and demand, or in case of the actual or threatened demolition or removal of any building erected upon the said premises, anything herein contained to the contrary notwithstanding.

Covenants of general warranty and further assurance.

FOURTH—That the mortgagor will execute any further necessary assurance of the title to said premises and will forever warrant said title.

Right of entry.

FIFTH—That if default shall be made in the payment of the principal sum mentioned in the said bond, or of any installment thereof, or of the interest which shall accrue thereon, or of any part of either, at the respective times therein specified for the payment thereof, the mortgagee shall have the right forthwith, after any such default, to enter upon and take possession of the said mortgaged premises, and to let the said premises, and receive the rents, issues, and profits thereof, and to apply the same after payment of all necessary charges and expenses, on account of the amount hereby secured, and said rents and profits are in the event of any such default hereby assigned to the mortgagee.

Receiver.

SIXTH—And the mortgagee shall also be at liberty immediately after any such default, upon proceedings being commenced for the foreclosure of this mortgage, to apply for the appointment of a receiver of the rents and profits of the said premises without notice, and the mortgagee shall be entitled to the appointment of such a receiver as a matter of right, without consideration of the value of the mortgaged premises as security for the amount due the mortgagee, or the solvency of any person or persons liable for the payment of such amounts.

Right of subrogation.

SEVENTH—And the mortgagor does further covenant and agree that, in the default of the payment of any taxes, charges, and assessments which may be imposed by law upon the said mortgaged premises, or any part thereof, it shall and may be lawful for the said mortgagee, without notice to or demand from the mortgagor, to pay the amount of any such tax, charge, or assessment, and any amount so paid the mortgagor covenants and agrees to repay to the mortgagee, with interest thereon, without notice or demand, and the same shall be a lien on the said premises, and be

secured by the said bond and by these presents and the whole amount thereby secured, if not then due, shall thereupon, if the mortgagee so elect, become due and payable forthwith, anything herein to the contrary notwithstanding.

EIGHTH—It is hereby further agreed by the parties hereto that, if at any time before said bond is paid, any law be enacted changing the law in relation to taxation so as to affect this mortgage or the debt thereby secured, or the owner or holder thereof, in respect thereto, then said bond and this mortgage shall become due and payable at the expiration of thirty days after written notice requiring the payment of the mortgage debt shall have been given to the owner of the mortgaged premises, anything herein contained to the contrary notwithstanding.

Brundage clause.

NINTH—The mortgagor, or any subsequent owner of the premises described herein, shall, upon request, made either personally or by registered mail, certify, in writing, to the mortgagee or any proposed assignee of the mortgage, the amount of principal and interest that may be due on this mortgage, and whether or not there are any offsets or defenses to the same, and upon the failure to furnish such certificate after the expiration of six days in case the request is made personally, or after the expiration of thirty days after the mailing of such request in case the request is made by mail, this mortgage shall become due at the option of the holder, anything herein contained to the contrary notwithstanding.

Covenant to give estoppel certificate. If the mortgagee wishes to sell the mortgage, this certificate will be demanded by the purchaser of the mortgage.

TENTH—It is expressly understood and agreed that the whole of said principal sum and the interest shall become due at the option of the mortgagee, upon failure of any owner of the above-described premises to comply with any requirement of any department of the City of New York, within six months after notice in writing of such requirements shall have been given to the then owner of the said premises by the mortgagee, anything herein contained to the contrary notwithstanding.

Acceleration of maturity. Caused by violation of municipal ordinances.

ELEVENTH—Every provision for notice and demand or request contained herein shall be deemed fulfilled by written notice and demand or request personally served on one or more of the persons who shall at the time hold the record title to the premises, or on their

Covenant as to communications.

heirs or successors, or by registered mail directed to such person or persons or their heirs or successors, at his, their, or its address to the mortgagee last known.

IN WITNESS WHEREOF, the said mortgagor hath signed and sealed this instrument the day and year first above written.

WILLIAM H. BOWEN (Seal)

Signed, sealed and delivered in
the presence of

JOHN DOE.

RICHARD ROE.

State of New York }
County of New York }^{ss.:}

On this 15th day of October, 1931, before me personally came William H. Bowen, to me known and known to me to be the person described in and who executed the foregoing instrument, and he duly acknowledged to me that he executed the said instrument for the purposes therein contained.

Notary's Official Signature.

(Notarial Seal.)

The above example of the real estate mortgage shows the kind of document given by the mortgagor to the mortgagee to secure the payment of money. Similar mortgages may be given to secure the performance of some other act by the mortgagor.²

This particular instrument was given in connection with a bond executed by the mortgagor, who promised to pay the stipulated sum to the mortgagee at a stated time. The bond evidences the debt, and the mortgage conveys the property as security for the debt. Occasionally, however, a real estate mortgage is given without an accompanying bond.

A corporate mortgage, that is, a mortgage given by a corporation conveying all or part of its property as security, differs in some respects from the real estate mortgage, but is based upon the same general principles. It will be discussed separately in Chapter X.

²Many states authorize the use of a *statutory* form of mortgage, much shorter and simpler than the above; but for other than somewhat small and routine transactions, most attorneys prefer to draw an individual mortgage especially covering each individual case.

Equity of redemption.—A glance at the foregoing mortgage will show that, if the form ended with the habendum clause, it would have the effect of a deed and the mortgagee would receive absolute title to the property. The next clause, known as the defeasance clause, however, provides that the mortgagor may satisfy the lien by paying the debt when and as it is due.

While the old form of the mortgage may be retained, ostensibly transferring the title to the mortgagee, modern legislation leaves the title in the mortgagor during the life of the mortgage, and also a continuous equity in the property equal in value to the excess of the property value over the amount of the mortgage. The privilege of the mortgagor to repay the loan in the manner set forth in the mortgage and free his property from the lien of the mortgage is known, as his *equity of redemption*.

Possession of mortgaged property.—Under the old Anglo-Norman *Vif-Gage*, property transferred to a creditor to secure repayment of a loan was taken actual possession of by the creditor, and he enjoyed all the rents and profits from it till he had been repaid the loan. The old *Mort-Gage* did not give the creditor actual possession, but provided that, if the debtor did not pay up the loan on the due day, title to the entire property went over to the creditor absolutely and forever.

The modern mortgage, however, does not give the mortgagee possession of the mortgaged property; and in case of default it gives him merely the right to sell and take his due in cash, and the remainder goes to the mortgagor as the value of his equity.

Operation of foreclosure claims.—If the principal of a mortgage debt is not paid at maturity, or if any default is made and thus brings about an accelerated maturity, the mortgagee will start proceedings of *foreclosure and sale* to procure a court order for the selling of the mortgaged property and the satisfying of his debt from the proceeds of the sale.

If there is only one mortgage on the property, the first of the proceeds, after the expenses of foreclosure and sale have been paid, go to the creditor, and anything remaining

goes to the debtor. If the property does not bring enough to satisfy the mortgage lien, the purchaser, nevertheless, receives a clear title; the creditor receives all of the proceeds and has a personal claim against the debtor for any balance of the loan not satisfied by the sale.

There is a rather widespread impression that if the proceeds from the sale of a piece of mortgaged property are not sufficient to satisfy the mortgage, the mortgagee loses the shortage; that he is, in other words, entitled to no more than the proceeds from the property which he accepted as security for his loan. This impression, of course, is not correct. The law looks upon the debt as the principal thing and the mortgage as an incident. If *A* owes *B* \$10,000, and *B* collects by sale of *A*'s property only \$7,000, then *A* certainly still owes him \$3,000. In other words, if *B*, through either his goodness of heart or ignorance of values, had advanced *A* money in an amount larger than *A*'s security warranted, he should not be penalized for it.¹ Where there are several successive mortgages, however, the procedure is not quite so simple as where there is but one. The foreclosure on any one mortgage brings about the settlement of all mortgages junior to it, but does not affect in any way the status of mortgages senior to it.

Thus, if foreclosure is made on the first mortgage, the buyer gets the property clear of all incumbrances and the purchase price (after the cost of foreclosure and sale has been deducted) will be applied to paying off all the mortgages in sequence. Any mortgagee or mortgagees concerned who find the proceeds exhausted before they are satisfied have a personal claim against the mortgagor for the amounts still due them.

Where foreclosure is made, let us say, on the second mortgage (and there are several successive mortgages on the property), the standing of the first mortgage is not affected; the purchaser acquires the property subject to the first mortgage, taking care, of course, not to pay more for the property than the difference between its real value

¹Emergency legislation in a number of states has had the effect of making it practically impossible to obtain a deficiency judgment if the property sells below its real value because of depressed economic conditions.

and the claim of the first mortgage. The first clear money from the sale then goes to pay the second mortgage and each in succession down the line; any unsatisfied mortgagee, as above, has a personal claim against the mortgagor but not against the specific property just sold. The effects of the foreclosure of any mortgage in the series can be analyzed in the same manner.

Suppose a piece of property to be security for four successive mortgages: the first for \$50,000; the second for \$30,000; the third for \$20,000; the fourth for \$10,000. To see the result of foreclosure and sale by any one of the mortgages, at various net prices, study the accompanying table.

TABLE OF MORTGAGE LIEN CLAIMS ON PROCEEDS OF SALE

<i>Foreclosed By</i>	<i>Purchaser Receives</i>	<i>1st Mtg. of \$50,000 Receives</i>	<i>2nd Mtg. of \$30,000 Receives</i>	<i>3rd Mtg. of \$20,000 Receives</i>	<i>4th Mtg. of \$10,000 Receives</i>	<i>Mortgagor Receives</i>
1st Mtg. Net Proceeds \$100,000.	Clear Title.	\$50,000.	\$30,000.	\$20,000.	Personal Claim on Mortgagor in the Sum of \$10,000.	Nothing.
2nd Mtg. Net Proceeds \$55,000.	Title Subject to the 1st Mtg.	Holds Mortgage as Before.	\$30,000.	\$20,000.	\$5,000 and Personal Claim on Mortgagor of \$5,000.	Nothing.
3rd Mtg. Net Proceeds \$30,000.	Title Subject to 1st & 2nd Mtgs.	Holds Mortgage as Before.	Holds Mortgage as Before.	\$20,000.	\$10,000.	Nothing.
4th Mtg. Net Proceeds \$15,000.	Title Subject to 1st, 2nd, and 3rd Mtgs.	Holds Mortgage as Before.	Holds Mortgage as Before.	Holds Mortgage as Before.	\$10,000.	\$5,000.

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Questions for Study and Review

1. How does business borrowing of today differ in character and purpose from that of former times?
2. Explain in detail the meaning of and the justification for trading on the equity.
3. Explain the statement, "Trading on the equity magnifies both profits and losses."
4. Explain and illustrate by assumed figures the terms *security* and *equity*.
5. Describe and summarize the contents of a real estate mortgage.
6. During the life of a mortgage, who has possession of the mortgaged property?
7. Explain what is meant by a junior mortgage; a senior mortgage; a prior lien.
8. If property sold under a mortgage does not produce sufficient money to satisfy all of the mortgagees in full, can they satisfy their claims in full in any other manner?
9. Explain how the foreclosure of any mortgage affects the standing of other mortgages on the same property.

Problems

1. Prepare a tabulation, similar to that shown in the text, showing, by means of a comparison of two similar businesses, the results of trading on the equity. The following data are given for your tabulation:

Business No. 1

Owned capital.....	\$400,000
Borrowed capital.....	none
Gross income, normal year.....	\$100,000
Operating expenses, normal year.....	\$60,000
Gross income, big year.....	20% above normal
Gross income, poor year.....	20% below normal

Business No. 2

Owned capital.....	\$400,000
Borrowed capital.....	\$400,000
(Borrowed capital obtained at 7% interest)	
Gross income, normal year.....	\$200,000
Operating expenses, normal year.....	\$120,000
Gross income, big year.....	20% above normal
Gross income, poor year.....	20% below normal

In each business, 60 per cent of the operating expenses is invariable and 40 per cent fluctuates with changes in the gross income.

2. A house and lot belonging to Mr. Hopkins is to be sold because the owner has defaulted on a third mortgage. Mr. Robinson wishes to purchase it for a home, but knows nothing of the details regarding mortgages and asks you for advice as to how much to bid for it at the sale and what title he will have to the property if he buys it.

You find that the property is assessed for tax purposes at \$20,000; that it is probably worth, at other than a forced sale, at least \$30,000; that it has a first mortgage of \$4,000, a second mortgage of \$8,000, and a third mortgage (now foreclosing) of \$5,000. Advise Mr. Robinson in detail.

3. Prepare a schedule of mortgage lien claims, under various foreclosures, upon the proceeds of sale (similar to that shown in the text of this chapter), using the following figures:

Amount of 1st mortgage.....	\$20,000
Amount of 2nd mortgage.....	8,000
Amount of 3rd mortgage.....	15,000
Amount of 4th mortgage.....	4,000
Sale under 1st mortgage foreclosure brings net	\$50,480
Sale under 2nd mortgage foreclosure brings net	26,925
Sale under 3rd mortgage foreclosure brings net	19,000
Sale under 4th mortgage foreclosure brings net	6,250

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4. Abbey & Company, manufacturers of a certain product by a secret process, have real estate conservatively valued for their own use and occupancy at \$100,000. It carries a first mortgage of \$50,000, a second mortgage of \$10,000, and a third mortgage of \$5,000. Business has been excellent, but at the present time it is in a precarious condition because of the need of \$20,000 for temporary funds. The proprietors as well as the mortgagees are confident that the company will pull through this crisis successfully if it can procure the money. If it cannot, then failure will probably result. The nature of the real estate is such that the property would be worth very little unless it were used by the present firm in its present business. Neither the owners nor the mortgagees can put up any more money, and outsiders have refused to advance any on a fourth mortgage. Advise in detail as to any solution to the problem that you may have.

CHAPTER X

The Corporate Mortgage

The corporate mortgage.—While the corporate mortgage follows the general lines of the real estate mortgage, there are a number of additional features which must be taken into account.

Corporations will, as a rule, mortgage not merely their real estate, but even the business itself, including the ground, buildings, machinery, stock, raw material, trade names, trade-marks, patents, goodwill, cash, accounts receivable, securities owned—in fact, their every asset. Thus, the corporate mortgage is much broader in its scope and requires much more detail in the description of the mortgage property than does the real estate mortgage. Furthermore, since the bonds issued under the corporate mortgage are almost always very large in number, and are often paid off in varying manners and at various times, the instrument becomes especially complicated in this respect.

A corporation may, of course, secure a loan through a regular real estate mortgage upon a certain piece of its property, or several loans by different mortgages on respective pieces of property, but the general practice, which happens to be also the best financing, is to avoid a number of small mortgages and to consolidate all loans as much as possible.

Other distinct features of the corporate mortgage follow in the succeeding paragraphs.

Mortgage bonds.—Borrowing corporations include, usually, our big businesses, and when they borrow, they do so in large amounts. It is impossible for one of them to procure a tremendous loan from one person and issue him a mortgage as security. It is necessary to have a large number of persons participate in these corporate loans; and each must be given an evidence of the indebtedness of the com-

pany to him, as well as be provided with security through a mortgage. To supply the evidence of indebtedness, the corporation issues its bonds to the persons lending the money.

A *corporate bond* is a written promise, under seal, to pay a specific sum of money (usually \$1,000) at a fixed time in the future (usually more than ten years after the promise is made); and it is generally one of a series of similar bonds, all of which carry interest at a fixed rate and are covered by a so-called deed of trust, or mortgage, in which the corporation's property is mortgaged to a trustee for the benefit of all the bondholders.

A person lending money to a corporation and accepting its bonds as evidence of the debt is said to *buy* the bonds, and he thereby becomes a bondholder of the corporation. These instruments are fully transferable; consequently one may buy a bond from a bondholder and become a bondholder himself years after the flotation of the loan, and yet have no direct transaction with the issuing corporation itself.

The trustee.—While it is perfectly feasible to evidence the debt of the corporation to each of the lenders by issuing to him bonds in the amount of his contribution, it is manifestly impracticable to execute a mortgage to each one in order to secure his individual loan. The matter of mortgage security is provided for by executing only one mortgage, which secures all the bonds issued under it and is made out not to the bondholders direct, but to a trustee who holds it for the benefit of all the bondholders. Under the Trust Indenture Act of 1939, a trustee must be “a corporation organized to do business under the laws of the United States or of any state or territory . . . which is authorized under such laws to exercise corporate trust powers, and is subject to supervision or examination by federal, state, or territorial authority.” The act further provides that the trustee shall have a combined capital and surplus of not less than \$150,000. The above law undoubtedly contemplates a continuation of the usual practice of appointing a national bank or trust company as trustee. This has been the practice for many years and is desirable because a corporation has continuous life and is more likely than a natural person to be impartial, independent, and capable; in addition, banking corporations are subject to governmental supervision.

A corporation acting as a trustee in a corporate mortgage sometimes finds it difficult or impracticable to perform its functions in states outside of one in which it is organized, and for this reason many modern mortgages name a natural person (a citizen of the United States) as a co-trustee with the corporation, so that he may, under his constitutional rights, act freely in any state where the corporate trustee may find it impracticable to operate.*

In such a case the corporation is known as the *corporate trustee*, and the natural person as the *individual trustee*.

Parties to the corporate mortgage.—From the foregoing it is clear that one of the essential differences between the real estate mortgage and the corporate mortgage is that the latter is an instrument of three parties while the former is of only two.

The three parties to the corporate mortgage are the corporation, the bondholders, and the trustee.

The corporation gives the mortgage in order that it may keep possession and control of its property and at the same time assure the bondholders the greatest possible security. It therefore procures the loan at the lowest possible rate of interest.

The bondholders demand the mortgage in order that they may obtain and hold the earliest and the strongest possible lien on property to assure the repayment of their loan.

The trustee is served by the mortgage through obtaining thereby the legal right to protect the bondholders without assuming any correlative obligations.

The duties of the trustee are:

1. To authenticate the issue of bonds.

That is, to sign a statement on each bond affirming that it is in reality one of the bonds issued pursuant to the terms of the mortgage. This authentication is a warranty on the part of the trustee that its issuance does not exceed the amount of bonds authorized under the mortgage.

2. To represent the bondholders in the protection of their rights.

3. To enforce the lien in case of default.

4. To comply with the provisions of the Federal Trust Indenture Act.

Since the corporation mortgage is made out to the trustee

*The Trust Indenture Act of 1939 contains a provision permitting the

and not to the real lenders of the money, the question is frequently asked as to who is the mortgagee.

This is answered by stating that both trustee and bondholders are mortgagees, the former being designated as the *legal mortgagee*, and the latter as the *beneficial mortgagee*.

The opening clause of the corporate mortgage will, therefore, usually appear approximately as follows:

THIS INDENTURE, dated the fifteenth day of October, one thousand nine hundred and thirty-one, between the Upton Manufacturing Company, a corporation organized and existing under the laws of the State of New York, hereinafter called the "Company," party of the first part, and Oldham Trust & Savings Bank, a corporation organized and existing under the laws of the State of New York, herein called the "Corporate Trustee," and William C. Maple, herein called the "Individual Trustee," parties of the second part, WITNESSETH:

It will be seen, then, that the lenders or bondholders, who are really a party in the agreement, and who are the beneficial mortgagees, do not appear as a party in the mortgage; that document merely gives to the trustees a lien upon the property for the benefit of the bondholders. The rights and privileges of the bondholders are, however, fully set forth in the body of the mortgage.¹

Form of the bond.—While the mortgage gives the security to the bondholders by giving a lien to the trustee on the property of the corporation to guarantee the repayment of the debt and the payment of the interest, the bond is the document naming some specific amount (usually \$1,000) to the extent of which the bondholder participates in the entire loan and in the protection of the mortgage, in other words, the corporation's *evidence of debt* to him.

The bond should be worded carefully so as to set forth its purpose in a clearly understandable manner.

To every bond of the coupon type (see page 173), there is attached a series of coupons, each of which is worth the interest for a period of six months. The coupon usually reads about as follows:

¹For a complete text of an excellent example of a corporate mortgage, see the mortgage of the Jones-Laughlin Steel Company, in Gerstenberg, C. W., *Materials of Corporation Finance*, pp. 183-254.

No..... \$25.00

On the fifteenth day of, 19...., the Upton Manufacturing Company will pay to the bearer at the agency of the Company in the Borough of Manhattan, in the City of New York, or at the office of the Oldham Trust & Savings Bank, in the City of New York, as the bearer may elect, twenty-five dollars in United States currency, being six months' interest then to become due on its First Mortgage Thirty-Year, Five Per Cent Bond No..... unless said bond shall have been called for previous redemption.

.....
Treasurer.

Then, there will also be the *certification of the trustee*, which authenticates the bond and which generally reads as follows:

This bond is one of the bonds described in the within-mentioned mortgage and deed of trust.

Oldham Trust & Savings Bank.

By.....
Trust Officer.

Types of mortgages.—After a corporation has decided to borrow money through mortgage bonds, it has to determine upon the manner in which the bond issue shall be carried out. This procedure is, of course, provided for in the mortgage; but three distinct types of mortgages have been developed and are in current use. These are the *closed end mortgage*, the *open end mortgage*, and the *limited open end mortgage*. Each will be explained separately.

The closed end mortgage.—The *closed end mortgage* is one under the terms of which the corporation may issue bonds in a certain designated amount and all at one time.

As far as the buyer of these bonds is concerned, the name means that he knows exactly how many bonds are secured by his mortgage at the time of its making, and he knows further that at no future time can additional bonds be issued under it, thus reducing his proportionate security.

To the corporation the name means that if, prior to the repayment of these bonds, it needs to sell other bonds and use the same property for security, it can do so only by

making another mortgage, which will be junior to the one in question. The bonds of the junior mortgage will probably have to carry a higher rate of interest or else be sold at a discount in order to counterbalance the lesser degree of security. Since a corporation is never by any means sure that it will not desire to sell more bonds within a few years, the closed end mortgages are not universally desirable.

The open end mortgage.—The *open end mortgage* is one which is just the opposite of the closed end mortgage; it simply authorizes the issuance of bonds without setting forth the number to be issued. Under such a mortgage a corporation may issue bonds in whatever number it sees fit; later it may put out another issue, and still later another, and so on as long as it can find purchasers. The various issues of bonds, though some may be dated years ahead of others, have no priority one over another; all are issued under the same mortgage, and in case of foreclosure all holders will share *pari passu* in the proceeds.

A bondholder who possesses bonds of one of the earlier series under such a mortgage faces the possibility of watching the equity grow thinner and thinner as the corporation continues to issue more bonds against the same property. In actual practice such a thing is usually avoided by placing in the mortgage certain restrictions, or *escrow provisions*, which protect the bondholder against the carrying too far of such future bond issuing. These restrictions will be taken up later.

The limited open end mortgage.—The *limited open end mortgage* has been devised to eliminate certain very apparent objections which are attached to the closed end mortgages and the open end mortgages.

This type of mortgage provides that a certain definite maximum number of bonds may be issued; it further provides that these bonds may be issued in different groups from time to time instead of being compelled to be issued all at once, as is the case in the closed end mortgage.

Such a provision is quite advantageous to the issuing corporation; it may authorize an ample issue of bonds at one time and under the same mortgage, but it may issue them in small or large lots, as they are needed from time to time.

The interest charges will thus have to be paid only on those bonds actually issued for money that is being used. This feature is the same as under the open end mortgage; however, under the limited mortgage it is known that the fixed maximum limit of bonds cannot be exceeded. Thus an absolute equity can be offered to bondholders just as under the closed end mortgage.

A limited open end mortgage is often more advantageous to the bondholders than a closed end mortgage of the same amount because, unless and until the limited open end bonds are issued up to the prescribed limit, there is additional equity back of the outstanding bonds, and interest is being paid only on bonds representing funds in actual use; while closed end bonds have from the start the minimum equity and entail interest payment on the full face of the mortgage. Moreover, while the limited open end mortgage authorizes a maximum issue which cannot be exceeded, this maximum issue may never be reached. Thus each bondholder is often given an even larger equity than he has been promised.

This type of mortgage is usually more advantageous to the bondholders than the open end mortgage, because under no circumstances can more than the stated number of bonds be issued. Thus the bondholders are assured at the very start of their security and equity, whereas under the open end issue the bondholders cannot tell how far their respective interests may be subdivided by the issuance of more and more bonds without definite limit.

All bonds issued under the limited open end mortgage, like those under the open end mortgage, are on exactly the same footing—none senior or junior to any other, regardless of the time of actual issuance.

Restrictions or escrow provisions.—From a general description of an open end mortgage it would appear that a corporation might persist in issuing bonds from time to time until the amount of bonds outstanding under the mortgage would be much greater than the entire value of the mortgaged property. Such a procedure would thus wipe out all equity and give only partial security. Indeed, such would be the actual case except for the fact that mortgages of this type contain certain restrictions or escrow provisions

to guard against this very thing and so protect the bondholder to a considerable extent.

These restrictions vary considerably in intent and in wording, but the usual ones are as follows:

1. After the issuance of a specified number of bonds, usually an amount for which the value of the mortgaged property would furnish a reasonable security, no further bonds shall be issued except in proportion to the increase in the value of the mortgaged property.

2. Bonds shall not be issued in greater number in any one year than is specified in the mortgage.

3. No additional bonds shall at any time be issued if their issuance would cause the total fixed charges to exceed a certain proportion of the net quick assets.

4. No additional bonds shall at any time be issued if their issuance would cause the total fixed charges to exceed a certain proportion of the annual net income.

5. No additional bonds shall be issued unless an annual improvement fund has provided for the improvement of the mortgaged property.

It may be seen quite readily that the insertion of several restrictions similar to some of these will serve to protect, both as to principal and interest payments, holders of bonds under open end mortgages.

In many cases the bonds authorized by limited open end mortgages are greater in amount than can be justified by the present value of the mortgaged property; the justification for such a practice is that the corporation wishes to have the large number authorized but intends to issue them progressively only as the value of the security increases and justifies such additional issues. In these limited open end mortgages there should be placed restrictions similar to those described above for the open end mortgage.

The after-acquired clause.—The corporate mortgage, like the real estate mortgage, is in form a deed with a defeasance clause and with certain covenants. It contains practically the same principal clauses and the same type of covenants as does the real estate mortgage but goes, of course, much further because it has clauses and covenants describing the bonds and setting forth in great detail the rights of the bondholder and the obligation of the company in regard to them.

There is one clause, however, appearing almost invariably in corporate mortgages and not in real estate mortgages, which deserves special attention. This is the *after-acquired clause*. By this clause the mortgagor company provides that, in addition to all the property set forth in the description clause, there shall also come under this mortgage, as additional security to the bondholders, all other property that the mortgagor company may acquire during the life of the mortgage.

Since progressive and prosperous corporations are usually expanding and acquiring additional property, and especially since the proceeds from the sale of bonds are often used immediately for the purpose of acquiring additional property, this after-acquired feature of the mortgage tends to give the bonds greater security and makes them sell at a better price or at a lower interest rate than they otherwise might. This, of course, is the exact purpose the corporation had in view when it placed the after-acquired clause in the mortgage.

Temporary avoidance of the after-acquired clause.— While the insertion of this clause in the mortgage usually has the desired effect of making the bonds marketable on favorable terms, it often reacts upon the corporation in an undesirable manner later on. Suppose, for instance, that a corporation has its entire property mortgaged to secure bonds and that the mortgage contains an after-acquired clause. The company desires to procure considerable new property, expecting to pay for it in large part from the proceeds of bonds secured by a mortgage to be placed on the new property. It now becomes evident, however, that the moment the company takes title to the new property, it falls under the old mortgage through the operation of the after-acquired clause, and that the best security the company can offer the buyer of bonds issued under the mortgage on the new property would be a mortgage junior to the one already existing and covering all the company's property, both old and new. These junior mortgage bonds would be undesirable, at least to the extent that the company would have to sell them at considerable discount or else pay a rather high rate of interest upon them. This, in

many cases, might preclude absolutely the acquisition of the new property.

Naturally, the company now wishes the original mortgage contained no after-acquired clause. The latter cannot, however, be taken out or dispensed with; but several ways have been devised to avoid the immediate consequences. The best-known methods for accomplishing this end are:

1. *By a refunding mortgage.*—The procedure followed in refunding bond issues will be discussed in detail in the following chapter. It is sufficient to say here that in the refunding process a new mortgage is issued and the bonds secured by it are offered to holders of bonds secured by the after-acquired clause mortgage, or are sold and the proceeds used to pay off these holders of the original issue who prefer the cash. When this operation is completed, the refunding mortgage replaces the mortgage containing the after-acquired clause, and the sale of additional bonds secured by the refunding issue will provide the funds necessary for the acquisition of new property.

2. *By using a purchase money mortgage and a financing company.*—The mortgages thus far considered have been those given for the purpose of securing the repayment of borrowed money. There is in common usage also the *purchase money mortgage*, one given by the purchaser of property to the seller to secure for the latter the payment of all or a part of the purchase price. Thus, Mr. A may sell a certain property to Mr. B for \$30,000, receiving \$10,000 in cash and retaining a purchase money mortgage on the property for \$20,000. Mr. B gets, not the actual clear title to the property bought, but in reality a \$10,000 equity in it. A purchase money mortgage on property takes precedence over any other lien that may be placed upon it by the mortgagor, and hence an after-acquired clause mortgage will have a superior lien not on the new property, but only upon the equity which the purchaser has in it. There may be instances where the owner of the property will not accept a purchase money mortgage, or the property may consist of several parcels divided among many owners. In such a case, there may be formed an intermediary financing com-

pany or syndicate which will put up the cash to pay for the property. The purchase money mortgage is then executed to a trustee, bonds are issued against it, and the proceeds from the sale are used to pay off the construction company, which, having served its purpose, is now completely out of the transaction.

3. *By lease*.—This method of financing the purchase of new property is chiefly confined to railroad equipment, and its principal feature is the transfer of the title of the property upon a down payment by the railroad company to a trustee who leases the property to the railroad. The railroad issues equipment trust notes in a series, a certain part being paid for each year. When the last of the series of notes is paid off, usually at the end of the tenth year, the trustee transfers the title of the equipment to the railroad company. Of course, until the railroad company has title, the equipment is not subject to the after-acquired clause lien of the mortgage. Such a method of purchasing equipment is known as the *Philadelphia Plan*. Equipment trust notes and bonds will be discussed further on in this chapter.

4. *By a conditional sale agreement*.—In many instances a *conditional bill of sale* instead of a lease is given to the railway company. This procedure, however, works out exactly the same as with the lease: the sale is not consummated and the title is not passed to the railway company until the last of the equipment notes are paid off. Where the conditional sale agreement is used instead of the lease, the plan is generally known as the *New York Plan*.²

5. *By means of a subsidiary company*.—In this plan, title to the new property sought to be acquired is taken by a subsidiary corporation, and since legally such a corporation has an identity separate from that of the parent holding corporation, it may issue a mortgage and bonds in its own name for the purpose of acquiring the property, which will not be subject to the after-acquired clause mortgage of the

²For a complete example of a conditional sale agreement and an equipment trust lease agreement, see Gerstenberg, C. W., *Materials of Corporation Finance*, pp. 299 and 313.

For an excellent description, see Chamberlain and Edwards, *Principles of Bond Investment*, Chapter XXVI.

parent company. The parent company may lend marketability to the bonds of the subsidiary company through a guarantee of the interest and principal.

6. *By means of consolidation.*—A corporation with an after-acquired clause in its mortgage may *consolidate* with one or more other corporations, absolutely giving up its individual corporate being and becoming only a part of an entirely different corporate entity. In such a case, additional property acquired by the consolidated company cannot be considered as newly acquired property of only one of the constituent companies. This fact effectually protects the new property from the action of the after-acquired clause of an old mortgage.

Classification of bonds.—It has been shown in the discussion in Chapter VIII that there are many types of stock with which the corporate organizer must be familiar so as to make a wise selection for his company. Similarly the corporation which contemplates financing by means of bonds has many kinds from which to choose. The names of these are often confusing due to the fact that the name applied to a bond is not always truly descriptive of the character of the security. It is advisable in all cases for a prospective investor not to rely upon the name appearing on the face of a bond, but rather to go back to the mortgage and therein read carefully all the characteristics of the security in question.

In order to grasp the meanings of the principal names applied to bonds, it is well to classify them into certain general groups. Chamberlain and Edwards, in their *Principles of Bond Investment*, first classify all bonds into two groups, according to the character of the issuing corporation: *bonds of civil loans*, and *bonds of corporation loans*. The civil loans embrace government loans and municipal loans, with all their various subdivisions, and are outside the scope of this work. Bonds of corporate loans, however, we shall consider in some detail.

For the purpose of study, corporate bonds may be classified on five bases as follows:

1. On the basis of the purpose to be accomplished.
2. On the basis of the security of the principal.
3. On the basis of the amount of income the bondholders are to receive.
4. On the basis of the manner of payment of the interest.
5. On the basis of the manner of payment of the principal.

Under each of these main headings may be grouped certain classes of bonds, aggregating practically all the important types, in accordance with the following scheme:

SCHEME OF BOND CLASSIFICATION

GROUPING OF CORPORATE BONDS.	On Basis of Purpose to be Accomplished.	{ <ol style="list-style-type: none"> 1. Purchase money, construction, extension, or improvement bonds. 2. Consolidated or unified bonds. 3. Adjustment or reorganization bonds. 4. Funding or refunding bonds.
	On Basis of Security of Principal.	{ <ol style="list-style-type: none"> 1. Prior lien bonds. 2. First, second, third, etc., mortgage bonds. 3. Bridge, terminal, dock, divisional, etc., bonds. 4. First and consolidated, first and refunding, general mortgage, etc., bonds. 5. Debenture bonds. 6. Receiver's certificates. 7. Collateral trust bonds. 8. Car or equipment trust bonds. 9. Assumed, guaranteed, indorsed, and stamped bonds.
	On Basis of Amount of Income Bond- holder is to Re- ceive.	{ <ol style="list-style-type: none"> 1. Bonds of stipulated interest rate. 2. Income bonds. 3. Profit-sharing bonds. 4. Participating bonds. 5. Tax-exempt bonds.

{	On Basis of Manner of Payment of In- terest.	1. Registered bonds.
		2. Coupon bonds.
		3. Coupon bonds registered as to principal.
		4. Interchangeable bonds.
{	On Basis of Manner of Payment of Principal.	1. Gold, silver, and legal tender bonds.
		2. Redeemable or callable bonds.
		3. Convertible bonds.
		4. Serial bonds.
		5. Sinking fund bonds.

With the above outlines clearly in mind, we may proceed to a detailed discussion and study of each of the subordinate classifications.

Purchase money and similar bonds.—Bonds given as whole or part payment for property acquired through purchase or construction, or as an extension or improvement, take names corresponding to their purposes, as: *purchase money bonds, construction bonds, extension bonds, improvement bonds*. These bonds are issued under mortgages of similar names, and constitute a lien on the property prior to any that can be placed thereon by the mortgagor. It must be noted that where bonds are sold to the public to procure funds to be used for purchases, construction, extension, or improvement, they are not purchase money, construction, or improvement bonds in the sense noted in this paragraph; they are, instead, regular mortgage bonds issued as evidence of a loan, and hence have their regular place in a line of mortgages and not the first preference of the purchase money mortgage. In other words, if bonds are sold to the public and the proceeds are used to purchase property, or for any other purpose, they are *loan bonds*; but if the bonds are given to a property owner, a construction company, or a syndicate in direct payment for their property or services, then they are true purchase money, construction, extension, or improvement bonds.

Consolidated or unified bonds.—Corporations, especially railroads, sometimes have several issues of bonds of varying dates of issue, various times of maturity, and probably various rates of interest. These have been issued from time

to time in a way which may be described as *hand-to-mouth financing*. In such instances, it is desirable and quite customary to combine, consolidate, or unify these several issues into one single large issue supported by a single blanket, general, unifying, or consolidated, mortgage, under which the new bonds take the appropriate name.

In issuing such unifying mortgage bonds, a sufficient amount is generally authorized, not only to take care of the total amount of outstanding issues but also to provide for future issues for a considerable time.

Such unification greatly simplifies the company's finances and gives the bonds the desirable quality of marketability in a much greater degree than ever possessed by the superseded issues.

Occasionally the issue of consolidated bonds is not large enough to consolidate all bonds outstanding, and later another consolidated issue is put out to consolidate more old issues. In such cases, those first issued are known as *first consolidated mortgage bonds*, and the later ones as *second consolidated mortgage bonds*, and so on. This does not mean that they have first and second lien on the property but merely that they are the first and second consolidated issues from the standpoint of date of issue (See discussion of **First and consolidated bonds** further on in this chapter).

Adjustment or reorganization bonds.—Bonds bearing these names are used and issued at the reorganization of a company to adjust claims against the old property, usually in an attempt to cut down the bonded indebtedness and reduce fixed charges. Though they are sometimes unsecured, they are generally issued under junior mortgages and receive their interest only if it be earned. They are, in fact, usually income bonds, which will be described later in this chapter.

Funding or refunding bonds.—*Funding bonds* are those issued for the purpose of converting floating indebtedness into a bonded indebtedness.

Refunding bonds are those issued for the purpose of raising funds to retire previously issued bonds. Often many of an issue of refunding bonds are not sold on the market at all but

are simply taken over by old bondholders in exchange for bonds of the old issue turned in. Where an earlier issue of bonds is refunded in whole or in part into a later issue, the later issue obtains for the benefit of all of its holders the proportionate claim of the refunded bonds in the earlier lien. Funding and refunding will be treated in detail further on in the next chapter.

Prior lien bonds.—*Prior lien bonds* are bonds issued under a mortgage which, with the consent of old bondholders, takes precedence over one or more mortgages already on the property.

First, second, third, etc., mortgage bonds.—These terms are used to indicate the order in which the mortgages back of the respective bond issues are placed upon the property. The first mortgage is first in point of time and is the senior lien upon the property. The others follow in consecutive order.

Bridge, terminal, dock, and divisional bonds.—*Bridge, terminal, and dock bonds* are usually those of a bridge, terminal, or dock company secured by a mortgage on the specific property of the company. Such a company is often owned by, or else leases its property to, one or several railroads jointly. The roads which use the property generally guarantee the interest on such bonds to guard against the possibility of loss or use through foreclosure of the mortgage.

Of course, one railway company alone may construct its own terminals, bridges, and so forth, and issue bonds against them; but it is both cheaper and more convenient to use joint freight yards, union stations, common bridges, and the like, and a separate company is usually formed to take charge of these.

Divisional bonds are those of a railroad secured by a mortgage on some particular division. They usually represent bonds of a mortgage on property which was formerly a separate railroad, but which has now become a branch or division of a larger one.

First and consolidated, first and refunding, etc., bonds.—Bonds bearing the names *first and consolidated*, *first and refunding*, and *first and general mortgage* are confusing because of their titles. In the first place, they are not first

mortgage bonds in the sense that they represent a first lien on all the property of the issuing company. They are secured by a first mortgage on a portion of the company's property, but on the remainder they may be only second, third, fourth, fifth, or lesser liens, due to various existing underlying mortgages on different parts of the property. They become first mortgages on other parts of the property as they replace older bonds either by consolidation, refunding, or purchase. It is the usual intent that these bonds shall eventually replace those of all existing mortgages and thus, in reality, become a first lien on the entire property.

The term *general mortgage bonds* means bonds secured by a general or blanket mortgage on all the company's property, already subject in whole or in part to prior mortgages.

Debenture bonds.—*Debenture bonds* are bonds not secured by a specific lien; that is, they have no security other than that of the general assets and credits of the issuer.

All government, state, and municipal bonds are debenture bonds, not being secured by mortgages or any other specific pledge of assets.

Private corporations, however, also use debenture bonds upon occasion. Their strength depends upon the general strength of the issuing company and the equity in the general assets over other bonds having prior lien. Their certainty of receiving interest regularly depends upon the size and regularity of the excess of annual earnings over the amount required to meet prior charges.

Receiver's certificates.—When a concern is unable to meet its obligations, application for a receivership may be made by a creditor or committee of creditors, or by the trustee for bondholders whose bonds have been defaulted upon. If the application be granted, a court will appoint a receiver to take charge of the business and to act for the benefit of the creditors. It is sometimes the duty of the receiver to liquidate the business and distribute the assets to creditors and owners in lawful sequence and proportion. On other occasions, however, he is to operate the business in an attempt to build it up and make it again an active concern. When his duty is to carry on the business, the receiver generally needs immediate working capital for the purpose. In such a

case the court may authorize the issuance of receiver's certificates. These certificates are, in effect, bonds, usually for short terms and sometimes secured. To give them marketability, the court generally arranges that they take precedence over other existing mortgage bonds. It is quite common to place them ahead of all bonds, though often they are placed just ahead of the issue of bonds at the request of whose owners the receiver was appointed. The reason given for the latter procedure is that the proceeds of the certificates help to protect the property for all the junior bondholders.

Collateral trust bonds.—A concern owning securities, bonds, or stocks of other companies—either separate companies or subsidiaries—may deposit them in trust as security for an issue of its own bonds. Bonds secured thus rather than by real property, are known as *collateral trust bonds*. Holders of such bonds are protected by the general credit of the issuing company, the market value of the pledged securities, and the value of the property of the companies whose securities are put up as collateral.

Car or equipment trust bonds.—Bonds secured by a mortgage or lease on rolling stock or other standard equipment, under the Philadelphia Plan (Lease) or the New York Plan (Conditional Sale) of procuring equipment, are known as *car trust bonds* or *equipment trust bonds*. Because of the first lien which these securities have on the equipment and because of the usual practice of issuing them in series so that the longest maturity will arrive many years before the expiration of the normal life of the equipment, these bonds rank high in security of principal. Since the amount outstanding is reduced at a more rapid rate than the depreciation of the equipment, the security really improves with each year; so that when only the last of the bonds are outstanding, they are as well if not better secured than at the outset. Standardization of railway equipment in this country, which makes it possible to transfer ownership of the equipment to another railroad, lends further security to the bonds. Even when railroad properties are in receivership, the receiver usually continues payment of inter-

est on equipment trust securities, because the equipment is necessary in the operation of the property.

Assumed, guaranteed, indorsed, and stamped bonds.—When one corporation acquires another by purchase or merger, or gets control through lease or ownership of a majority of the stock, it assumes the latter company's debt, including its bonds. These bonds are then known as *assumed bonds*. Assumed bonds are not necessarily guaranteed bonds, though they are sometimes erroneously given that designation. The assuming company may guarantee them; but unless it specifically does so, they are not guaranteed bonds, though, of course, the assuming company is responsible for the payment of interest and principal without the specific guarantee.

When a company other than the issuing company guarantees the payment of interest or principal, or both, on certain bonds, they are known as *guaranteed bonds*. Such guarantee is intended to strengthen the market value and the loan value of the bonds. When the bonds are guaranteed at their issue, the terms of the guarantee are usually recited on the face of the bonds. Often, however, they are guaranteed after issue, and the guarantee appears on a separate instrument.

One corporation may simply indorse the bonds of another, thus implying a guarantee of payment and assuming liability just as does the indorser of a note. This practice gives rise to *indorsed bonds*.

It is sometimes desired, subsequent to original issue date, to make some changes in the tenor of bonds; such as, to add a new condition to which they are subject, or to insert some new privilege to which they shall be entitled. Such addenda may be stamped on the bonds, which thereupon are known as *stamped bonds*.

Bonds of stipulated interest rate.—The great majority of all bonds are issued to bear a *specified or stipulated rate of interest*. This is paid to the bondholder annually or semi-annually, always at the same rate. The income is not affected in any manner by fluctuations in the company's earnings or by any action on the part of directors or officers

in the company. This interest constitutes a fixed charge on the company. A *fixed charge* has been defined as a charge whose non-payment will cause the company to lose possession or control of its property. That is what happens in the case of non-payment of the fixed or stipulated bond interest. Immediately upon default in any payment, the bondholder may foreclose through the trustee, and proceed to collect both interest and principal.

Income bonds.—Bonds are sometimes issued with the condition that interest at a certain rate will be paid upon them only if it is earned in excess of other fixed charges. Such bonds are known as *income bonds*. Their interest does not constitute a fixed charge; and failure to pay it, except when earned, does not give the bondholders the right to sue. If the earnings available for income bond interest are not sufficient to pay the full amount, then such portion as is earned is usually paid.

Income bonds often rise out of reorganization, where holders of defaulted bonds accept in their stead income bonds. They may be secured by a junior mortgage; they may be collateral trust bonds; or they may be simply debentures. They may be either cumulative or non-cumulative.

Profit-sharing bonds.—*Profit-sharing bonds* have a fixed minimum rate of interest enforceable as is the interest on any other bond with a fixed interest rate; and also, in addition to this, they share in excess earnings of the issuing company. Any method of profit-sharing may be arranged.

Participating bonds.—Profit-sharing bonds, as described above, are frequently called *participating bonds*; in fact, the two terms are frequently used interchangeably. The term *participating* is also used in a slightly different sense as follows: Collateral trust bonds are sometimes issued with a provision that they not only shall receive their regular rate of interest, but also shall participate in any extraordinary interest or dividend upon the securities which constitute their collateral security.

Tax-exempt bonds.—The United States Government exempts from all federal income taxes all pre-war issues of government bonds; the First Liberty 3½s; state bonds; bonds of insular possessions; bonds of municipalities, dis-

tricts, or political subdivisions of a state; Federal Land Bank Bonds; and Joint-Stock Land Bank Bonds. Other issues of Liberty Bonds are partially exempt. The various states similarly exempt from state income taxes the same government bonds, their own state bonds, and bonds of their own municipalities and subdivisions. All such bonds are known as *tax-exempt bonds*. The term *tax-free bonds* is applied almost indiscriminately to the same bonds. The latter term, however, might more properly be applied to taxable bonds issued with a tax-free covenant clause. This is an agreement that the issuing corporation will itself pay the normal income tax on such bonds without deducting it from the interest payments to the holder. Under the present revenue law, the issuing company can pay this normal tax only to the extent of two per cent.

Registered bonds.—Registered bonds are those which have the owner's name written on the face and which are registered on the records of the issuing corporation. They can be negotiated only by indorsement and transfer on the books of the company. They have no interest coupons, but the company sends the interest at each period to the person recorded on its books as the owner. A bank or trust company is usually appointed as registrar for bonds of this class and keeps complete records of all issuances and transfers. The complete history and ownership of each bond can thus be traced.

Coupon bonds.—A *coupon bond* is one which is not registered in the name of the owner and which, at maturity, is payable to the bearer, the title passing by delivery without indorsement.

A coupon bond has attached a series of coupons. Each coupon entitles its holder to the interest for the period represented by it. The coupons themselves are negotiable promises to pay the interest for certain periods, just as the bond itself is a promise to pay the principal when due. To collect the interest for a stated period on a coupon bond, the holder simply clips off the appropriate coupon and presents it for payment to the issuing company or its fiscal agent. As a matter of fact, the holder usually simply deposits it in his bank for collection.

Registered coupon bonds.—Some bonds bear negotiable coupons to take care of interest payments but have the body of the bond, representing the principal, registered. This combination is known as a *registered coupon bond*, or a coupon bond registered as to principal.

Interchangeable bonds.—Some bond issues consist of both coupon and registered bonds. A buyer may take his choice, and then if he so desires after purchase, he may exchange his bond for the other type. Such are called *interchangeable bonds*.

Gold, silver, and legal tender bonds.—Some bonds state the medium in which their payment is to be made and take their names accordingly. *Gold bonds* usually specify that they are payable in "gold coin of the present standard of weight and fineness." Under the recent "Gold Decision,"¹ the Gold Clause in bonds was abrogated, and holders of gold bonds must now accept any legal money. Whether or not this will remain a permanent condition cannot be foretold. *Silver bonds* are not used in the United States.

Redeemable bonds.—Bonds which by the terms of their issue may be called for redemption by the issuing company before the date of their maturity are known as *redeemable* or *callable bonds*. It is quite common to issue bonds which are redeemable at certain specified times, or within certain time limits, or upon certain notice. To compensate the holder for the loss of his investment, a redemption price somewhat above par value is usually set.

Convertible bonds.—*Convertible bonds* are those which are convertible at the option of the holder into other securities of the issuing corporation. The conversion privilege usually means the right to convert into preferred or common stock and is set at a certain ratio: sometimes par for par; sometimes at a given figure, as at 110, or 120, and so forth. When a company issues bonds convertible into stock, it must have authorized and available sufficient stock to make the conversion if required.

Serial bonds.—Bonds of a single issue, but made up of various groups with varying dates of maturity, are known as *serial bonds*. It is customary to divide the entire issue into

¹ 55 *Supreme Court Reporter* 307 (1935).

a number of groups, having the groups mature successively at equally distant periods. The periods between maturities of the various groups are sometimes as small as six months and sometimes as long as several years. The system provides for methodical and gradual reduction of the issue. The entire issue bears the same rate of interest; hence, if the bonds are sold below par and redeemed at par, the yield on the shorter-term ones will be larger than that on those of longer terms. The yield is generally made uniform by arranging a varying scale of prices which constantly diminish as the terms of the bonds increase, thus making all the bonds equally desirable and salable.

Sinking fund bonds.—*Sinking fund bonds* are bonds issued under an agreement whereby the issuing corporation is required to set aside regularly out of earnings a sum which, with interest, will be sufficient to redeem the bonds at maturity. This agreement gives the bondholders absolute assurance of a systematic provision for repayment of the loan. The sinking fund payments are obligatory, and failure to make them gives the bondholder the same rights as would a default in an interest payment.

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Questions for Study and Review

1. How does the corporate mortgage differ from the simple real estate mortgage?
2. Define a corporate bond.
3. Name the three parties at interest in a corporate mortgage and state how the instrument affects each.
4. Explain in detail three types of corporate mortgages.

5. State two of the most generally used escrow provisions in open end mortgages. What purpose do such provisions serve?

6. Explain the meaning of the purchase money mortgage; the after-acquired clause.

7. Name six ways of avoiding the after-acquired clause.

8. What are the advantages to a corporation of issuing consolidated or unified bonds?

9. Under what circumstances may prior lien bonds be placed upon a corporation's property?

10. Are *first and consolidated* or *first and refunding* bonds secured wholly by a first mortgage? If not, why is the corporation justified in using the word *first* in their title?

11. Explain in detail the actual security back of collateral trust bonds.

12. Distinguish between profit-sharing bonds, participating bonds, and income bonds.

13. a. Is there any difference between a coupon bond and a fully registered bond endorsed in blank?

b. Why do coupon bonds usually sell a trifle higher than registered bonds of the same issue?

14. Distinguish between sinking fund bonds and serial bonds.

Problems

1. A public utility corporation, Company A, has outstanding \$2,500,000 worth of bonds secured by a closed end mortgage. It desires to do considerable extension work in new territory and to acquire \$500,000 worth of new property each year for the next six years. Its average annual surplus, after the payment of 5 per cent dividends on its stock, amounts to \$100,000.

Explain how the company can best finance the extension: (a) assuming that the \$2,500,000 mortgage has no after-acquired clause; and (b) assuming that it has an after-acquired clause.

2. a. The Atlantic & Western Railroad is in need of \$800,000 worth of rolling stock. All of its present property is mortgaged, and the mortgage contains an after-acquired clause. The road has only \$150,000 available toward purchasing the needed equipment. Explain how it can finance the purchase of the equipment.

b. Suppose that in Part a of this problem the equipment obtained by the railroad depreciates to a junk value of \$30,000

by the end of twenty years. Explain how the equity back of the equipment trust notes will constantly increase if the entire issue is matured by the end of the tenth year.

3. Corporations *A*, *B*, and *C* have, respectively, 6, 12, and 24 directors; and each has a provision for cumulative voting. They have stocks outstanding as follows: *A*, \$15,000,000 common; *B*, \$6,000,000 common and \$6,000,000 preferred; *C*, \$9,000,000 common and \$5,000,000 non-voting preferred. The par value of all stocks is \$100. The stock of Corporation *A* is selling at par; of *B*, \$70 for common and \$90 for preferred; of *C*, \$80 for common and \$100 for preferred. With what minimum investment could you get control of all three corporations? Explain how you would finance the acquisition.

4. The Acme Corporation has outstanding \$1,000,000 of 6 per cent first mortgage bonds; \$500,000 of 7 per cent second mortgage bonds; \$200,000 of 6 per cent income bonds; and \$2,500,000 of common stock. What rate of income on the face of the investment will each class of security bring if there is paid out in interest and dividends (a) the sum of \$95,000; (b) the sum of \$107,000; and (c) the sum of \$250,000?

CHAPTER XI

Conversion, Refunding, and Redemption

Extinction of bonded indebtedness.—A bond represents a debt of the issuing company, and the bondholder is a creditor of the company. The bond, in addition to being an evidence of indebtedness, is also a written promise to repay this indebtedness at some definite time in the future. Thus, when a corporation issues bonds, it is its expressed intention and compulsory duty to make satisfactory settlement with the bondholders at or before the maturity of the bonds; and the bondholders purchase the bonds because they are assured of this definite settlement. A plan of bond financing, therefore, is not complete unless it takes into consideration the method for extinguishing the bonds.

The normal procedure in a bond issue is that the instruments, having a certain maturity date, seldom less than ten and usually not less than twenty years, be sold to the public; that regular interest be paid on them either annually, semi-annually, or quarterly during their entire life; and that upon the maturity date, the issuing company call in the bonds and pay each holder in cash the face value of his certificate, which payment constitutes the redemption of the bonds.

The exigencies of business, fluctuation of interest rates, demands of investors for additional features in bonds, and many other things, however, bring about conditions under which many bonds do not run this normal course of being paid in cash at maturity, but are settled for with various mediums either at maturity or at some prior date.

A bonded indebtedness of a corporation may, therefore, be extinguished either at or before maturity. There are three methods of so doing, known respectively as *converting*, *refunding*, and *redeeming*; each will receive separate consideration.

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Extinction by conversion.—*Conversion* means simply the exchanging of one security for another, and usually consists in the exchange of bonds for stock. The conversion privilege is exercised, almost without exception, wholly at the option of the bondholder, but such privilege is limited entirely to bonds which, by the terms of their issue, are made convertible. Companies can, however, and sometimes do, offer a conversion of an issue of bonds which was not convertible at the time of its issue.

When bonds are converted into stock, the former bondholders (creditors) become stockholders (owners); hence, the bonded debt of the corporation, as represented by the converted bonds, has been wiped out. If, however, the bonds had been convertible into a different issue of bonds instead of into stock, which is quite unusual, the corporation would not, upon conversion, have reduced its bonded indebtedness; it would, rather, have substituted one set of bonds for another. This same result is attained by refunding, which will be discussed later.

Reasons for having convertible bonds.—When convertible bonds are issued, their conversion rights constitute a claim upon the stock or other security of the company which the company is compelled to recognize at the bondholders' demand, whether or not convenient or desirable; hence, the question naturally arises as to just why a corporation should issue convertible bonds. The answer is that all securities are sold for the purpose of raising capital, and the corporation must issue such types as will prove the most readily marketable and bring the best price. Often a company cannot, through either its stock or its bonds, offer the three factors desired by the purchaser (adequate income, lack of risk, and control), nor even any one of them in a degree to make the security desirable. In such a case a convertible bond might fit in admirably. It would give safety of principal and a certain ratio of income. Also, it would give the holder the privilege of later trading it in for stock in case the company prospered so that its stock paid a high rate and was reasonably secure; the control would come indirectly, with the other desirable features of the improved stock.

As far as the corporation is concerned, the conversion of

bonds into stock furnishes a convenient and relatively easy way of getting rid of bonded indebtedness and the fixed interest charges incident thereto; it has been accomplished simply by a further division of the ownership and without any cash payment. Since conversion is rarely made unless the company is in a growing and prosperous condition, it does not work a hardship on the old stockholders.

Rates of conversion.—Convertible bonds are made convertible into another security at some given ratio. For example, one \$1,000 par value bond may be exchanged for 10 shares of stock. Sometimes the conversion basis is indicated by stating that the bonds are convertible into stock at 110, or at 120, or at some other specified figure. If this figure is set at 120, it means that the stock is being valued for conversion purposes at \$120 a share, or, in other words, $8\frac{1}{3}$ ($\$1,000 \div 120 = 8\frac{1}{3}$) shares of stock may be obtained by converting one \$1,000 bond. By watching the relative market prices, the bondholder may be able to convert without loss, or even at a gain, in spite of the fact that he gives a larger face value than he receives. When the market values are such that the bonds can be converted without loss, they are said to be at their *conversion point*.

Thus, if bonds are convertible into stock at 120 and the stock is selling at 102 per share, the bonds will be at their conversion point when they are selling at 85, which is tentwelfths of 102. For example, a person owning 12 bonds at a market price of 85, or a total market value of \$10,200, could obtain for them 100 shares of stock with a market price of 102, or a total market value of \$10,200. Therefore, the conversion can be made without loss. If, in this case, the bonds are selling above 85, the conversion is made at a loss; and if they are selling below 85, the conversion is made at a profit.

In an actual conversion an adjustment is made on account of the accrued dividends on the stock and the accrued interest on the bonds; the corporation charges the converter with the former and credits him with the latter. The difference is paid in cash by the party with the smaller credit.

Prices of convertible bonds.—Market prices of convertible bonds are not governed so much by the investment value

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of the security as are market prices of non-convertible bonds, because the convertible bond prices are influenced to a considerable degree by the market price of the stock into which they are convertible.

The true *investment value* of a bond means the valuation upon which it will earn the current rate of interest. Thus, if money is worth 6 per cent, a 6 per cent bond earning \$60 interest will be worth, as an investment, \$1,000; whereas, if money is worth only 5 per cent, the same bond would be worth \$1,200 as an investment; and, if money is worth 7 per cent, the same bond would be worth only \$857.15 as an investment. The *market value* of an ordinary bond will normally remain quite close to its true investment value, but the market value of a convertible bond may follow the market value of the stock into which it is convertible far above the investment value. For example, suppose a certain bond is convertible into stock par for par, and has an investment value of \$1,000. If the stock goes up on the market to \$120 a share, the bond should go up in about the same proportion; namely, to about \$1,200, because it is exchangeable at any time for stock which can actually be sold for that amount. When the market price of the stock begins to drop, the market price of the bond will drop with it. The stock, however, may be downward indefinitely, whereas when the bond has declined as far as its true investment value—in this case, \$1,000—it will decline no further. So we may make the general statement that normally the market price of convertible bonds will advance and decline along with the market price of the stock into which they are convertible, advancing with it to any extent, but declining with it only to the level of the true investment value of the bonds.

↓ **Extinction by refunding.**—*Refunding* is the exchange of bonds of one issue for those of another. It differs from conversion in this way: conversion is a special privilege accorded to the bondholder by the terms of his bond and usually means the converting of bonds into stock; refunding is not an enforceable right of either the company or the bondholder, but is a matter of mutual agreement between them, and means always an exchange of bond for bond.

An issue of bonds may be refunded at its maturity, or it

may be refunded prior to maturity. In either case, both holder and issuer must agree; and at no time can the company compel the bondholder to accept a new bond to succeed his old one, nor can the bondholder compel the company to issue him a new one to succeed his old one. At maturity, the holder can demand cash and the company can insist on paying in cash. As a matter of fact, refunding at maturity is seldom accomplished by an actual exchange of securities unless the company is embarrassed. In most cases, the new securities are sold in the open market in the regular way and the old ones taken up. Prior to maturity, both the holder and the company can decline to make a change of any kind, unless the bond be specifically either convertible or redeemable.

Refunding being an issuance of one set of bonds to be exchanged for old bonds outstanding does not, of course, do away with the bonded debt, but merely substitutes one set of bonds for another. It is not, therefore, in a strict sense, an extinction of the debt, but often extends it in point of time or reestablishes it on a new basis. The actual old bonds are taken in and canceled, and to that extent we may consider the debt to be extinguished and a new one made in its place.

Refunding at maturity.—When a series of bonds reaches its maturity, the holders may reasonably expect that they will receive the face value of the bonds. Often, however, it is not convenient or possible for the issuing company to pay off this debt. Or it may be that the company is perfectly able to pay off the bonds, but it can still continue to use the money profitably in the business. For one of these or for other reasons, it may wish to extend the loan. An issue of refunding bonds is then authorized; all the old bondholders will be invited to accept the new bonds in place of the expiring bonds, and thus extend the loan over the life of the refunding issue. Bondholders who demand cash instead of accepting new bonds are paid in cash through the selling of the necessary number of bonds to other investors.

Refunding before maturity.—Often bonds are refunded into a new issue before they have matured. This is usually done by the company either for the purpose of consolidating several outstanding issues, all refundable into one new issue,

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or in order to get the debt into a more desirable form as to term, interest rates, redemption price, or other features.

The refunding of several old issues into one new issue places all bondholders on the same footing; it makes the entire funded debt easier to handle; it gives the bonds greater marketability on account of the large size of the issue; and when the new issue is greater in amount than the combined old issues, thus making what are usually called *first and refunding bonds*, it enables its company to borrow additional moneys on this security, which it probably could not borrow on a separate bond issue junior to the old outstanding ones.

When bonds are refunded at maturity, the old issue always entirely disappears, either through being traded in for new bonds, or through being redeemed by cash obtained through the sale of the refunding bonds. When, however, an attempt is made to refund one or more old issues before maturity, a number of bonds of each of the old issues may still remain out, due to the refusal of the holders to give them up for either new bonds or cash. The success or failure of the refunding proposition depends upon the number of old bondholders who can be induced to trade in old issues for the new bonds. To persuade bondholders to refund, various inducements are frequently offered them in connection with the new bonds, such as: a higher rate of interest, better security, better marketability, a cash bonus, promise of a sinking fund, and others. If outstanding bonds are *redeemable* a complete refunding operation is greatly facilitated, for the bondholders realize that if they do not accept the refunding offer, then their bonds may be called by the issuing company.

\ **Refunding with aid of bankers.**—When a corporation has made all its plans and arrangements to carry out further financing through refunding, it would be disastrous if the refunding plan failed. Arrangements are, therefore, often made with banking houses or special syndicates to assure the taking of the entire refunding issue. By this arrangement, the bank or syndicate usually agrees to put up cash for any old bonds for which the old bondholders will not accept new bonds in exchange. For all cash thus advanced, the bank or syndicate takes new bonds and sells them to reimburse itself. The bank or syndicate is paid by means of a

straight commission or by being privileged to buy its necessary bonds at a discount.

Old bondholders, knowing that the successful completion of the refunding plan is guaranteed, are naturally more willing to enter into it, so that the securing of this bank aid not only furnishes cash for the redemption of bonds whose owners demand it, but also causes a greater number to be actually refunded.

Refunding by short-term notes.—It sometimes happens that at the maturity of a bond issue the current interest is so abnormally high that fixed charges on a new long-term loan would be prohibitive. The corporation will then attempt to refund the bond issue with short-term notes at a high rate, with the hope of refunding these notes in turn by long-term bonds when interest rates have again gone down. It is quite common to authorize the refunding issue of bonds at the same time the short-term notes are sold, and to put up the bonds as collateral security for the notes.

Characteristics of the short-term corporate note.—All notes are written promises of the makers to pay a sum of money to the payee (or holder, or bearer) at some future time, and in this respect are similar in purpose and character to bonds. As a matter of fact, no exact line can be drawn between notes and bonds. Bonds bear the corporate seal; notes may or may not do so. The usual distinction made between notes and bonds is in length of life. Short-term promises to pay—those having maturities up to five years—are generally called notes; long-term promises to pay, usually for ten years or more—are commonly called bonds. Yet, there are occasional issues of ten-year notes and five-year bonds. In other words, while the general rule that notes are issued for less than five years and bonds for more than ten years is usually true, the name that a promise to pay will bear depends principally upon what the issuing company sees fit to denominate it at the time of issue.

Like bonds, corporate notes may be either *secured* or *unsecured*. Unsecured notes are often called debenture notes and are almost always of very short life. The majority of corporate notes, and almost all of those of considerable duration, are secured. The security is almost invariably of the

collateral variety, consisting of stocks and bonds of other corporations held by the issuing corporation.

Notes are also issued in both *registered* and *coupon* forms.

Notes are sometimes made redeemable in order to permit a corporation to redeem them before maturity, if desirable; and to make them attractive to investors, they are sometimes made convertible into some other security of the corporation.

Some issues have a provision that a sinking fund must be established and maintained to better assure their repayment either at or before maturity: such are called *sinking fund notes*.

It is not uncommon in large note issues to have them mature in series, usually a specified number or proportion each year.

Occasionally there have been notes actually secured by a mortgage on property, or by the company's own bonds and it is not unusual to protect them by a provision to the effect that during their life the company shall not issue any other obligation which might take precedence over them.

Thus it may be seen that notes, while usually very simple, may possess practically all the attributes and characteristics of bonds.

Disadvantages of short-term notes.—The use of short-term notes has several disadvantages which must be carefully weighed against the advantages.

The immediate cost in interest rate is generally higher than that of bank borrowing, bond borrowing, or raising capital by stock selling. When notes are used as a temporary expedient in the place of bonds during an expectedly short period of high interest rates, it is impossible to predict just when, if ever, the rate will fall. If it does not fall soon, one or more renewals of the notes may be necessary; such action will, thus, not only carry on the high rate of interest for a longer period, but will also involve the cost of several resales of the refunding or extending issues.

Short-term notes sometimes fall due in the midst of an unexpected financial slump; such conditions make it almost impossible to meet them and very difficult to renew them. With long-term bond obligations, there is ample time to prepare for the maturity; but with the short-term notes, a sin-

gle error in judgment, a single improper forecast, or a single unlooked-for setback brings on the maturity unprovided for.

√**Extinction by redemption.**—Redemption is the actual paying off of the loan or debt represented by the bond. All bonds are redeemable at maturity and some, which are known as *redeemable* or *callable* bonds, are redeemable at the option of the issuing corporation at some time prior to maturity.

Redemption actually extinguishes the bonded debt absolutely, and severs all relations between the bondholders and the company; conversion changes the status of a bondholder to that of a stockholder; refunding simply gives the bondholder new bonds for old.

While bondholders may at maturity of their bonds accept bonds of a refunding issue, or may agree to any other settlement that the issuing company may offer, they usually have the right to demand payment in cash. If this is not made, they may foreclose upon the company and collect through the trustee of the mortgage.

Redeeming before maturity.—By the terms of the mortgage the issuing companies are sometimes given the option of retiring or redeeming the bonds before maturity. Times for redemption vary in different mortgages; sometimes redemption is permitted at any time; sometimes, at any time before a given date, after a given date, or between two given dates; and sometimes, on any interest date or on certain specified interest dates. In fact, the time or occasion of redemption may be fixed in any manner by the mortgage. It must not be understood that an entire issue need be redeemed all at one time before maturity. Such redemption, in fact, is very unusual. It is customary to redeem the issue in installments, either as the issuing company finds convenient or desirable, or as may be specified in the mortgage.

Redemption prior to maturity is at the option of the company, and no bondholder has the right to demand such redemption of his security. Of course, some mortgages provide that the company must redeem a certain number of bonds each year, and to this extent the company's option is abrogated.

Mandatory and solicited redemption.—Bonds may be

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called for redemption either *mandatorily* or *by solicitation*. Under the former method, the bonds to be redeemed are selected by lot and the holders notified by publication. They, thereupon, turn in their bonds at the redemption price. If for any reason whatever the holder of a called bond fails, or declines, to have it redeemed, the interest on it stops at the date set for redemption; the principal, however, is held indefinitely by the trustee for the bondholder. Some mortgages provide that if a bondholder does not demand his principal within a given number of years, the trustee shall return it to the company.

Under the solicitation method, the company can merely offer the redemption of a certain number of bonds, and request holders to turn them in. If an insufficient number are turned in, nothing can be done about the matter, except possibly to purchase bonds on the open market, provided they can be obtained at the redemption price.

Very frequently mortgages provide for a combination of mandatory and solicitation methods. The usual arrangement is that the company shall call for a certain number of bonds for redemption. If this solicitation does not produce the required number, the remainder of the quota for redemption may be mandatorily called by lot.

Redemption price.—The mortgage itself fixes the price which the company shall pay the bondholder for a bond called for redemption before maturity. This *redemption price* is almost invariably greater than the face value of the bond. The actual price is usually fixed at par, plus a round figure of about the amount of one year's interest. The total thus determined makes a great number of bonds redeemable at 105 and 110. It is believed that this bonus will serve to enable the person whose bond has been redeemed to take time to find another investment for his money without suffering any actual loss in interest. When a bond is redeemed at a high figure very shortly after its issue, it, of course, means a high rate of yield for the time the money was invested.

Sources of funds for bond redemption.—When bonds are redeemed for cash and are not merely converted or refunded,

there are two methods of providing the cash to take them up:

1. There is a voluntary setting aside of moneys received from earnings, or any other sources, in such amounts as make it possible to meet the bonds when they are to be paid either at or before maturity. This is done by the management as a matter of business and financial policy but not on account of any agreement or understanding with the bondholders.

2. There is the putting aside of a sinking fund to pay off the bonds. This sinking fund is made obligatory by the terms of the mortgage, and failure on the part of the company to make the prescribed payments gives the bondholders the right to foreclose.

A sinking fund may be provided to accumulate the cash for the redemption of any bonds; but it is used particularly in cases where there is danger of the shrinkage in value of the protecting assets, or in the case of extractive businesses the assets of which are actually used up in the operation.

Building of the sinking fund.—Payments into a sinking fund are provided for in a number of ways, but practically all can be classified under two general headings:

1. Periodical payments to be a *proportionate* or *fractional part* of some unit basis, such as a certain percentage of the gross earnings, of the net earnings, of the surplus, or of the amount of depletion of assets. The principal weak point in methods of this type is that if the company becomes inoperative or unproductive, the sinking fund does not grow, while the bonds still race toward maturity.

2. Periodical payments to be a *fixed* or *stipulated sum*. This method assures the regular growth of the sinking fund, but places upon the company a fixed obligation which it may not be able to meet in times of business depression or non-operation.

Many modern mortgages provide for the building of their sinking funds by a judicious combination of these two basic methods.

Serial redemption.—An issue of bonds is frequently put

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out in a number of series maturing in succession at regular intervals. This type of issue spreads the actual payment of the bonds over a long period, starting usually one year after the issue. Sometimes the entire issue is put out at the same time, and sometimes a few of the series are retained for future use.

The spreading out of the repayment can be accomplished without having the bonds in series, by using a sinking fund and redeeming certain numbers of bonds from time to time. In the case of non-serial sinking fund bonds, however, the purchaser never knows when his bond may be called for redemption and hence is always uncertain as to the life of his investment. In the serial bond issue, however, each bondholder knows at the start just when the series of which his bond is a part will be redeemed, and can arrange all his financial plans accordingly.

Serial bonds may be protected by a sinking fund as well as non-serial bonds, but the practice is not so common.

In arranging the series under a serial issue, two methods are used: first, each series may consist of the same number of bonds; and second, each series may consist of a greater number of bonds than its predecessor.

Under the first method, the reduction in interest each year due to the retirement of bonds accrues to the issuing company to be used for any desired purpose.

Under the second method, it is customary to make each successive series of such size as can be redeemed by the amount available for the redemption of the previous series plus the interest saved through its redemption. Thus, by utilizing the saved interest each period to redeem an increased number of bonds, they can be redeemed quite rapidly with a uniform outlay. This method is particularly adapted to public financing where the money to repay the bonds is obtained through taxation and remains constant in amount from year to year.

When bonds are redeemable at a premium, or when they are sold under par but are redeemable at par, those redeemed shortly after issuance will, of course, produce a considerably higher yield than those running a long time before redemption. In the case of serial bonds sold below par, therefore,

an adjusted scale of prices is usually arranged (the highest prices are for those bonds maturing first, and the lowest for those maturing last) so that the actual yield will be practically the same on all the series of the entire bond issue.

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Questions for Study and Review

1. Explain and compare the three methods of extinguishing bonded indebtedness.
2. Which usually sells higher, convertible bonds or the stock into which they are convertible? Why? Show how their respective prices may rise and fall comparatively.
3. Explain the difference between refunding and conversion. Contrast refunding at maturity with refunding before maturity as to purposed effect.
4. You hold bonds of two corporations, each of which is asking you to refund your bonds into a new refunding issue. Company A is refunding with the aid of a banker, and Company B is refunding without the aid of a banker. In each case, what questions would you determine before deciding whether or not to refund?
5. How can you distinguish between bonds and notes?
6. Describe the two principal conditions under which short-term corporate notes are issued.
7. What are the disadvantages of short-term notes?
8. Explain your opinion of the practice of financing long-term requirements by means of short-term obligations.
9. *a.* Suppose that you neglect or decline to send in for redemption a bond that has been properly called. What will happen to it?
b. Explain what is meant by mandatory and solicited redemption.
c. What are the disadvantages to an investor of redeemable bonds and what offsetting advantage does the issuing company usually offer?

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10. Name several methods of making payments into a sinking fund and tell the advantages and disadvantages of each.

11. Explain two methods and the advantages of serial redemption.

Problems

1. Mr. Ammons holds 40 bonds of the X Company, which are convertible into stock of the company at 125. The face value of the bonds is \$1,000, and the par value of the stock is \$100. The bonds are quoted on the market today at 107, and the stock at 105.

a. If Mr. Ammons converts today, will he do so at a profit or at a loss, and what will be the extent of his profit or loss?

b. With the stock still quoted at 105, what would have to be the quotation on the bond in order that he might convert without profit or loss? What are the chances that the bonds will reach this conversion point?

c. If the bonds remained at 107, what would have to be the quotation on the stock in order that he might convert without profit or loss? What chance is there that this will occur?

2. A company has an issue of \$2,000,000 of bonds which were sold at 80 and bear interest at the rate of 6 per cent. A proposition is made to refund the bonds at 110, out of the proceeds of a new issue of 4 per cent bonds to be sold at 80, and to run for the same length of time as the unexpired term of the old bonds; namely, seventy-five years. Assume that the company, in order to carry out the proposition, puts through the measure and arranges to retire, during the life of the bonds and in equal annual amounts, all the bonds required to be issued in excess of \$2,000,000. How much will the company save? (Make no allowance for savings on annual savings of interest.)

3. a. The Zenith Company is formed to acquire the Curwood property and to take over the Adams Corporation and the Beadle Corporation. It has authorized a \$4,000,000 issue of bonds, of which \$1,000,000 worth are to be sold at par and the proceeds used to buy the Curwood property. The remaining \$3,000,000 worth are to be reserved to refund the outstanding bonds which have been issued by the Adams Corporation and the Beadle Corporation, amounting respectively to \$1,800,000 and \$1,200,000.

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The Zenith Company succeeds in refunding only \$1,080,000 of the Adams bonds and \$900,000 of the Beadle bonds.

The Zenith Company then fails, and the three constituent properties are sold separately, bringing \$1,500,000, \$1,000,000, and \$800,000, respectively, for the Adams, Beadle, and Curwood properties. What percentage of the face value of their investments would the holders of the various bonds receive? (Do not consider the expenses of foreclosure, sale, taxes, etc.)

b. Under all the above conditions, what liens had the various bondholders on each of the properties: first, before any refunding; and second, at the time of the company's insolvency?

4. A company is about to raise \$10,000,000, and the current interest rate on bonds is 8 per cent. This high rate is not expected to last for more than six years, after which time it is anticipated that interest rates will have declined to 6 per cent. Should the company issue straight twenty-year, 8 per cent bonds; twenty-year, 8 per cent redeemable bonds, redeemable at 108; or should it issue short-term (three-year) notes? (Let it be presumed that bankers will make a charge of 2 per cent for selling any type of bond or note considered in this problem.)

CHAPTER XII

Capitalizing the Corporation

The meaning of the financial plan.—The *financial plan* of a corporation has a two-fold aspect; it refers not only to the capital structure of the corporation, but also to the financial policies which a corporation has adopted or intends to adopt. Upon those responsible for the formulating of the financial plan fall the duties of:

- ✓ 1. Determining the amount of capital to be raised.
2. Determining the form of capital securities to be issued and the proportionate amounts of each.
3. Adopting policies for the proper management and administration of the capital.

✓ Naturally, as the word *plan* implies, the above decisions must be made in the light of expected future developments. The possibility of expansion, or of merger or consolidation, will have an influence upon the capital structure; so, also, will trends in the capital market and other factors affecting the marketing of securities which will be discussed later.

The causes of many present day reorganizations and recapitalizations, costly to corporation and security holder alike, may often be found in the lack of proper financial planning at the time of initial promotion or at times of later expansion. Many complicated and unwieldy capital structures in existence today are the direct result of piecemeal financing without definite plans.

The financial plan is seldom stated in a formal way as such; rather, it finds expression in the certificate of incorporation and in the by-laws and minutes of stockholders' and directors' meetings. The plan to be effective should have all the provisions affecting the capital structure systematically assembled in one place. If this is done, changes may be

made with regard to their effect on the whole; thus, the orderly development of the corporation's financial policies is insured.

The capital budget.—The rapid rate of expansion of many businesses often makes it imperative that a long-term forecast of capital requirement be made. Some large industrial plants and public utilities work out plans from five to ten years ahead. Naturally such plans are not accurate as to detail, but they do attempt to forecast expansion possibilities in such a way that the financial plan may be so shaped as to provide for financing the projects and also to avoid hazardous growth. As each year passes, the forecasts are revised and a new year added to the plan. The plans for the coming year are gone over very carefully and worked out in detail; the financial requirement is carefully estimated, and a budget established. The budget is broken down into months and shows in detail the projected capital expenditures so that adequate provision can be made for funds. The advantages of having planned so far ahead become apparent when current budgets are considered.

When a company knows in advance approximately what is required in the way of materials and funds, bids can be obtained, cost estimates prepared, and perhaps tentative contracts awarded. It is also possible to acquire raw material or sources from which these may be obtained. For example, a telephone company needs thousands of poles every year; this demand often means that timberlands must be leased or acquired to insure the supply. As far as finances are concerned, reserves can be set up to provide for expansion and plans made to enter the capital markets at the most propitious time.

Purposes in raising capital.—No business can be established without at least some outlay of capital. In financing a business, funds must be provided for the following purposes:

1. To defray the costs of organizing.
2. To finance the acquisition of fixed assets.
3. To cover the cost of establishing the business.
4. To supply working capital.

The cost of organizing the business.—By the *cost of organizing the business* is meant the cost of promotion, including the compensation of the promoters, legal fees, investigation costs, organization taxes, and all expenses of like nature, sometimes referred to as *intangible costs*. These expenses, prior to the financing of the business, are borne by the promoters or investment bankers organizing the business. It is only fair that this cost should be passed on to the ultimate owners or stockholders, since it is as much a cost of the building of a business as is the cost of the bricks for the walls. True, when the business is finally organized, there will be no tangible asset in the balance sheet to represent these expenditures; but, as will be seen, capitalization is not determined by tangible assets alone.

The cost of fixed assets.—In most businesses, certain tangible assets—such as furniture and fixtures, buildings and equipment—must be purchased before the businesses are opened for trade. Estimates of such costs are usually made during the promotion stage; but the actual acquisition of such assets does not take place until financing is either completed or well under way, though as part of the assembling stage in promotion, contracts may be let providing for such assets.

The costs of establishing the business.—In many lines a large part of the *costs* of doing business are more or less *fixed*, and the costs do not vary directly with the volume. The business, therefore, must be built up to a certain point before these fixed costs can be absorbed in the selling price of the product and profits realized. Selling prices are determined by the public demand for the product and, of course, bear a direct relation to its utility. Hence, prices at the outset usually cannot be fixed at a point high enough to absorb the high unit costs attendant upon low volume. A simple illustration will make this clear. Suppose the fixed costs of the business amounted to \$16,000 a month and the variable costs; that is, the cost of material and labor, were \$20 per unit. Also, assume that the product could be sold at a price not greater than \$40 each, providing a margin of \$20 above the variable costs. If 400 units only were sold the first month at this price, the fixed costs to be borne by each

product unit would be \$40; this would entail a loss per unit of \$20, on account of fixed costs alone. If, in the second month, 800 units are sold, all the fixed costs are absorbed and the *break-even* point has been reached; the business is now operating without profit or loss from this account. Thereafter as volume increases, profits will likewise increase. Of course, it must be understood that there are limiting factors. The so-called fixed costs will eventually rise to some extent, and the selling prices may have to be lowered to bring in a larger number of purchasers.

It may be several months before production reaches a profitable volume. Undoubtedly many months elapsed before Mr. Ford's Model A car was produced in sufficient volume to render a profit. In fact, after a business is actually started, a month or several months may elapse before the product is ready for the market or, in the words of the production manager, "until the factory is tooled up and into production." The losses during this period due to lack of momentum are the *costs of establishing the business* and must be considered in computing the amount of capital required. These costs result in an intangible asset often called *going concern value*,¹ which conservative accounting dictates should be written off subsequent profits, but must be provided for in raising capital at the outset.

The working capital requirements.—In addition to the funds necessary for investment in the plant and equipment, or so-called *fixed assets*, it is necessary to provide a certain amount for investment in the *liquid* or *current assets* of the concern. Some cash must be kept on hand, since not all customers pay cash, and inventories of finished goods and raw materials must be financed. The total current asset investment in the business represents the *working capital* of the business. While some of the working capital may be obtained from temporary sources, the greater part of it should be permanently provided for through the sale of stock or long-term bonds.

Determining the amount of capital to be raised.—Obvi-

¹ The item of *going concern value* rarely appears as a balance sheet item; the expense is charged off as incurred. Public utilities frequently include the item among their assets for rate-making purposes.

ously the amount of capital necessary is determined by the sum of the organization costs, the costs of tangible assets, the costs of establishing the business, and the working capital requirements. However, the *capitalization* of the business; that is, the determination of the amount of the securities to be issued, is not arrived at in this manner. Capitalization should be based on earning power. In other words, the process of capitalization begins with an estimate of the future net income of the business. No one puts money into a business without expecting a return upon it in the shape of dividends or interest. The value of a business is determined by its ability to earn a return upon capital invested. - The higher the rate and regularity of its earnings, the greater the value of the business and the greater the amount of capital which may safely be invested in it. Another way of stating the same thing is to say that a business is worth that amount upon which a fair return may be realized. A fair return contemplates compensation for the use of capital and for the assumption on the part of the investor of the risks pertinent to the business.

Suppose, for instance, in the promotion of a manufacturing business, it is determined that \$60,000 a year can be earned with regularity and that earnings in this type of business are ordinarily 10 per cent on invested capital. The business may be capitalized at 10 per cent; dividing \$60,000 by .10 gives a quotient of \$600,000, which would represent the total par value of the capital securities to be issued. In other words, we have assumed here that this business is worth ten times its earnings.

If it be desired to use stock without par value, the price at which it is desired to market the stock is the deciding factor. Should it be desired to sell the stock at \$40 a share, the earnings per share if the stock is to sell ten times the earnings must be \$4. Dividing \$60,000 by \$4 we have 15,000 shares as the number to be issued.

If the capitalization arrived at in this manner is not sufficient to pay all of the costs of starting the business, including the costs of the tangible assets, the proposition should be reconsidered, for the assets must be capable of paying a fair rate of return on the amount to be invested in them.

Estimating the earnings.—Where the promotion is that of a consolidation or where it represents the public offering of stock in a new corporation formed to take over a closed corporation, the past earnings of the concern often offer the best basis upon which to estimate future earnings. But in an entirely new company, the problem is difficult. *Earnings* depend not only upon the assets but also upon the skill of the management. The latter is an intangible factor and difficult to appraise. Where management is a very important factor, considerable conservatism should be shown in making estimates of earnings. Probably the best basis in a new enterprise is to study the earnings of concerns similarly situated in similar businesses. Such information can be obtained from the published reports of such concerns, from statistical agencies, and from newspapers. Conservative estimates should be the rule, for if earnings are overestimated, overcapitalization will result.

As will be pointed out later in this chapter, the stability or regularity of earnings is almost as important a factor as the expected average amount of those earnings. The regularity of earnings has an important effect on the choice of securities.

Determining the capitalization rate.—One of the most difficult steps in arriving at the capitalization of a corporation is the determination of the *capitalization rate*. The rate at which a concern should be capitalized should always equal that return on the invested capital which would adequately compensate the investor for the use of his funds and the risk which he undertakes. No set rules can be established, for the investor's desires in the matter change with the times. When business is good, the public is optimistic and thinks lightly of the risks involved. At such times capitalization will more than likely be at a low rate and will give a higher value to the enterprise. But in times of business depression the public takes a very pessimistic view of the value of securities and is likely to exaggerate the risks to be run. A business which might be capitalized at 10 per cent in a period of prosperity would have to be capitalized at perhaps as high a rate as 20 or 25 per cent to attract purchasers to its securities in a period of business depression.

At any one time the capitalization rate can best be determined by noting the price at which securities of similar businesses sell and by observing the earnings of those companies. If the common stock is selling at an average of 10 times the earnings, the capitalization rate is 10 per cent. This rate will indicate that basis of capitalization which at the moment will best facilitate the marketing of the securities. Of course, a new concern will not, as a rule, be able to capitalize at so low a rate as the stock prices and earnings of more established concerns might indicate. While there are some exceptions, even in prosperous times the buyers of securities will place a higher value on the stock of a well-known concern than on that of a new one with no earnings record.

However, despite the rate established on the basis of the values assigned to similar businesses by security buyers, those responsible for the financial plan of a corporation may well have a mind to the future in times when they might be tempted to capitalize at too low a rate. A low rate of capitalization results in a large issue of securities. While they may command a good price during prosperous times when such a low rate is possible, they are bound to fall in price as the first note of pessimism strikes the ear of the security buyer; and the market decline may seriously injure the credit of the corporation and make future financing difficult.

It is axiomatic that the greater the risk, the higher must be the capitalization rate. The rate will be higher in those enterprises where skill in management is a more important factor than advantage of location or excellence of assets.

Where no-par value stock is used, the same procedure is followed, and the number of shares may be ascertained by dividing the value (ascertained by capitalizing the earnings) by the price at which it is desired to sell the stock.

Choosing the type of securities to be issued.—Once a value has been placed upon the business, the problem arises as to the best type of securities to issue and the proportionate amounts of each. There are certain fundamental rules for the choice of securities, which may be accepted as established principles:

1. Bonds should be issued only when future earnings are

expected to be reasonably stable and well above the interest and sinking fund requirements.

2. Preferred stock may be issued where the average earnings over a period of years are expected to be well above the preferred dividend requirements.

3. Where earnings cannot be predicted with reasonable certainty, common stock should be used.

Obviously no corporation is capitalized entirely with bonds or with preferred stock. Combinations of bonds, preferred stocks, and common stocks are frequent. So great, however, is the need for certainty of stable earnings if bonds are to be used that it is only in comparatively rare instances that a new business obtains capital in this way. Bonds are more likely to be issued at a subsequent period after years of operation have demonstrated the stability of earnings. Holding companies are, of course, an exception, as they often have bonds in the original capital structure. Here it is the earnings record of the subsidiaries which furnishes the basis for bond issues.

Preferred stock is often used in financing a new business because it gives a claim on the earnings, and often upon the assets, ahead of that of the common stock holders and because the high rate of dividend offered attracts investors who do not care for the risk borne by common stock holders.

Common stock is usually taken by the promoters and in a favorable market is sold to the investors. It is often used as a bonus to purchasers of preferred stock in order to stimulate the sale of the latter.

Experience has shown that, while exact rules as to the amount of bonds and preferred stock which can be issued cannot be established for all businesses, general rules can be laid down which are helpful. In the case of railroads, bond interest should be earned 1.50 times; preferred stock dividends, 2.50 times. In the case of public utilities, bond interest should be earned 2 times and preferred stock dividends, 2.50 times; while in the case of industrials, where stability of earnings is usually lacking, bond interest should be earned 2.50 times and preferred stock dividends, 3.00 times. With these ratios in mind it is easy to establish the proper propor-

tions whenever the amount of earnings can be estimated with reasonable accuracy. In the case of industrials, which are usually subject to wide fluctuations in earnings, prudence dictates that the poorest rather than the average years should be taken as the criterion, especially where it is expected that bonds will form a part of the capitalization.

Other factors affecting choice of securities.—While the principles outlined in the last paragraph should be adhered to as far as possible in making up the financial plan, there are other factors which exercise a very important influence on the choice of securities and upon the proportion of the various kinds of securities to be used. Some of these factors may at times be so important as to limit the choice to a given type, or types, of securities, regardless of the fact that it may be more prudent or desirable to finance through the use of another medium. Some of the more important of these factors are:

1. The traditions and present style of the security market.
2. The desire for control on the part of the promoters.
3. Plans for future expansion.
4. The cost of financing.

1. *The traditions and present style of the security market.*—The vagaries of the security buyer's demands are not surpassed by the patrons of a millinery shop. There are times when not only an entirely different kind of security is demanded by the buyer but when the general type must be modified and given special features to make it attractive. There are times, also, when it is easier to sell common stock than any other class of security. The period from January, 1928, to October, 1929, furnishes an example of such times. Almost any type of common stock was popular; but in order to sell bonds and preferred stocks, special features had to be annexed to such securities. Such features were the privilege of converting into common stock, or the practice of giving option warrants with the bonds or preferred stock (the warrant being a right to buy common stock at a certain price). To sell bonds alone, in many cases, would have necessitated offering them at low prices or high interest rates; such a practice made this type of financing too expensive. During

the period, common stocks were in such demand by a speculatively minded public as to command good prices for the poorest and most speculative securities. In periods of depression, it is usually bonds that are desired by security buyers, because (1) low money rates and low corporate earnings make these lower-yield securities more attractive and (2) the investor is afraid to risk his money in stocks which are more or less speculative.

In order to maintain the desired proportion of securities, corporations sometimes offer their securities in units; that is, they may offer for sale a unit consisting of two shares of preferred and one common, or they may offer common as a bonus with preferred stock. After all, the money in many cases must be raised; and, willingly or unwillingly, the corporation's officers with the advice of his banker must modify the financial plan to meet the desires of investors. Corporations forced to issue bonds or preferred stock in such instances should make them convertible or redeemable so that the financial plan may later be readjusted when common stock becomes popular. On the other hand, when common stock only can be sold, the concern is deprived of the advantages of trading on the equity for the time being, though the situation is not so serious as when the market will absorb only bonds or preferred stock. The difficulty of marketing common stock in periods of depression is one reason why few promotions of new enterprises and consolidations are undertaken at such times.

2. *The desire for control on the part of the promoters.*—The element of control is also important. Formerly it was customary to compensate buyers of stocks which did not carry the voting privilege by making such stock preferred as to dividends and often preferred as to assets, too. In more recent years it has been found that, in most cases, the general investing public is so little concerned about the voting privilege that non-voting common stock can be issued to provide a large amount of the capital, while control is vested in a small amount of voting common held by the promoters. The non-voting common, in many recent promotions, differs in no way from the voting common, except in the denial of the voting privilege. The custom has grown up of referring

to the non-voting common as class A stock and to voting common as class B stock. Since, however, in many cases the same classification is used to distinguish between preferred and common, the nomenclature is by no means standardized. An example of this type of financing is found in the Roxy Theaters Corporation, which has a class A stock, that is cumulative, no-par, participating, preferred as to assets to the extent of \$50 a share in liquidation, but which is non-voting; and it has a class B common which carries full voting privileges. At the time of offering, one share of common was given as a bonus with two shares of preferred.

The necessity of making preferred stock and bonds convertible may also create a control problem that involves the privilege of converting into voting stock. The necessity arises, as indicated above, in meeting the demands of investors during the marketing of securities. When the earnings become attractive, holders of bonds or preferred stock bearing this privilege will convert into voting stock and thereby endanger control. This danger can be overcome by issuing warrants to those in control which give options to purchase sufficient voting stock at low prices, to insure, if exercised, the possession by the present management of a controlling interest. Even though the options evidenced by the warrants are never exercised, the possibility of the warrants being so utilized would probably keep control in the hands of the original voting stockholders.

The voting trust may also be utilized as a device to insure the retention of control in a certain group. The Pennroad Corporation was organized for the purpose of investing in railroad securities for the furtherance of plans of the Pennsylvania Railroad. The Pennsylvania Railroad itself was unable to hold these securities without the express permission of the Interstate Commerce Commission. In order to finance the Pennroad Corporation and still keep control in the hands of the Pennsylvania Railroad, without direct stock ownership on the part of the latter, the Pennroad stock was deposited, upon issuance, with voting trustees who were directors of the Pennsylvania Railroad, and only the voting trust certificates were sold to raise capital.

The big problem that confronts an inventor who may have

spent years and a fortune in developing his invention to the point of marketability is, "How can I, without losing control of my invention, finance a company to manufacture and market this product?" It can readily be seen that the control factor may exercise a very important influence on the choice of securities in the financial plan.

3. *Plans for future expansion.*—Every business must grow; it cannot stand still. It is not to be implied that the business must grow larger in terms of total assets and that it must spread out into many divisions and branches, but it must keep up with the times and the natural trends in its own community. Plants must be modernized to keep up with the progress of science and inventions and with the demands of their customers, who need new products. If a business does not keep pace with the times, it favors competition and may irretrievably lose its markets. Public service corporations must expand with the growth of population and industry in the territory served, or they fail to give the service demanded by their franchises. Nor is it desired to indicate that all concerns expand only because circumstances have forced such action. The natural pride and desire for gain and prestige on the part of the owners and managers usually provides sufficient stimulus for expansion.

Expansion in many cases may be entirely financed through the plowing back of earnings into the business. Certainly this method is followed to some degree by all businesses. The possible exceptions are the public utilities where the rates charged are supposed merely to represent a fair return on existing property; hence, earnings on capital invested may be inadequate to allow as large a margin above reasonable dividends as might be the case with industrials.

However, extensive expansion is likely to require new capital. If the business has already burdened itself with a mortgage which has heavy fixed charges, or if the mortgage contains an after-acquired clause, future financing may be difficult. The same difficulty will be experienced if the business has an excessive amount of high dividend preferred stock outstanding. The possibility of growth should always be kept in mind when any financing is undertaken, and care

should be taken not to handicap progress in future years because of heavy expenses in the earlier ones.

4. *The cost of financing.*—The cost of financing and its effect on the financial plan has already been touched upon in the discussion of the varying demands of the security buyers at different times. It is desired here merely to further emphasize that, however desirable it may be to finance with a certain type of security, the high interest or dividend rates and the low prices at which that type of security might have to be sold may make it too expensive to use. To some extent a corporation may overcome this handicap by making bonds or preferred stocks (when the market dictates that these be used) redeemable or, perhaps, convertible into common stock. This will allow the corporation to redeem at a time when common stock meets with favor and can be sold. Or, if the corporation becomes prosperous, the holders of securities which bear the conversion privilege may convert them to enjoy the higher return offered by common stock ownership.

Overcapitalization.—When a business is unable to earn a fair rate of return on its outstanding securities, it is *overcapitalized*. Overcapitalization may be the result of overestimating earnings at the time of promotion, or it may be due to subsequent developments which reduce the earning power.

An illustration of the latter situation, that is frequently cited, was the rapid decline of the bicycle business, which resulted in the failure of the American Bicycle Company. The bicycle was being considered a necessity; it turned out to be a fad. The trend in fashions which affect a basic product, such as the decline in the use of woollens for women's apparel, is another illustration of what may happen to the market. Indeed, we are constantly overwhelmed with proof that

“The best laid schemes o’ mice an’ men
Gang aft agley.”

Whether overcapitalization is the result of errors in the original plan, or whether it is due to developments during the succeeding years, it may result in the following disadvantages:

1. Where a large part of the capitalization consists of bonds, there may be a failure to pay the fixed charges; such a failure results in foreclosure or reorganization.

2. The credit of the concern is injured; and financing of any kind becomes very difficult.

3. Securities decline in price; and holders grow dissatisfied.

✓ 4. The business loses to its competitors through inability to obtain funds for expansion.

5. The management is tempted to reduce depreciation and maintenance charges in order to keep up dividends.

6. Where reorganization takes place, the resulting publicity may injure the goodwill of the business.

Remedies for overcapitalization.—Overcapitalization presents a situation that is extremely difficult to remedy. The problem may involve one or more of the following steps:

1. Reduction of the amount of bonded indebtedness.
2. Reduction of the rate of interest paid on bonds.
3. Reduction of the par value of the stock.
4. Redemption of high dividend preferred issues.
5. Reduction in the amount of common stock outstanding.

Without going through an outright reorganization, the procedure for which is discussed in a subsequent chapter, it is practically impossible to reduce the amount of bonded indebtedness in such a way as to remedy overcapitalization. Funds for the redemption of bonds would have to come from the sale of stock. Since the stock would be selling at low prices, due to the failure of the overcapitalized company to earn a fair rate of return, the amount of stocks to be sold to raise the money would be large and, instead of remedying the situation, they might aggravate it.

No bondholder, unless the proposition is made very attractive to him by way of a premium, could be induced, for instance, to turn in a 6 per cent bond and to accept a 4 per cent bond in return. In a reorganization, he might be forced to do so to protect the principal of his investment; but short of such an extremity, adjustments of this kind are hard to bring about. In a refunding operation involving the payment of a

premium to the old bondholders who turn in their old bonds for lower interest-bearing bonds, the annual saving in interest charges is usually not large, because of the necessity of issuing a greater amount of bonds to cover the premium; and the corporation often finds, after the transaction is complete, that it has a greater bonded debt than before with a saving of interest charges insufficient to remedy the state of overcapitalization.

The stockholder will not, as a rule, accept a lower par value stock in exchange share for share. A *split-up* of a higher par into several shares of lower par, of course, leaves the aggregate amount of stock capitalization the same. While it is true that the par value of the shares held by the stockholder has nothing to do with the real value of his shares, and that the acceptance of a share at lower par value does not diminish his proportionate share of ownership in the corporation, the average stockholder is inclined to believe otherwise; and it would be difficult and unadvisable to try to convince him to the contrary.

It is often expedient, from the point of view of the common stockholder, to redeem high dividend preferred stock. This is particularly true where such dividend requirements substantially reduce the amount of earnings available for distribution to the common stock. While, as in the case of bonds, funds for redemption must come from the sale of common stock at low prices, the saving thus effected may increase the return available for the common.

The reduction of the amount of common stock outstanding is also difficult to accomplish because it is hard to persuade the stockholder, for example, to turn in two shares when he will receive only one in return. Again, it is to be noted that, while this would not decrease his proportionate ownership, the average stockholder could not be convinced that his position would not be damaged by the procedure. However, the tendency of stockholders to follow the lead of the management and to send in proxies giving the management full authority makes it possible to reduce common stock capitalization in some instances. The reduction, in a ratio of one new share for three old, accomplished by the Electric Bond & Share Company in March, 1932, is an illustration of common

stock recapitalization. This corporation received the approval of its stockholders for a change from approximately 14,700,000 no-par common shares, with a stated value of \$10 a share, to 4,917,000 shares with a par value of \$5.

Undercapitalization.—When a corporation is earning an extraordinarily large return upon the amount of stock outstanding, it is said to be *undercapitalized*. Undercapitalization is not to be confused with a condition implying lack of funds; it refers merely to the amount of stock outstanding. The situation is recognizable through the very high prices its stock consistently commands on the exchange and is due, also, to the fact that the earnings of the corporation are regularly very high. The condition is not so serious as a state of overcapitalization, though the following disadvantages do exist:

1. The limited market and the unusually small supply of stock cause large fluctuations in the market price.
2. The stock usually does not command so high a price as warranted by its earnings, because of the limited number of purchasers.
3. The high rate of return may stimulate competition.
4. In the case of large combinations there may be governmental action under anti-trust statutes.

It might seem that the corporation need not concern itself about the price at which its outstanding stock is sold on the exchange nor with its fluctuations. Nevertheless, it may find that the rumors and the publicity which accompany wide fluctuations in the price of its securities may react unfavorably upon the corporation and affect its credit and its business.

Where the amount of stock outstanding is small, any substantial buying and selling of its shares causes wide fluctuations in the price, and much unfavorable publicity may result.

As to the disadvantage from the standpoint of competition, this disadvantage is more theoretical than real, for competition will recognize a good thing without waiting to see the earnings statement of the corporation.

Probably many governmental investigations and legal

actions brought against corporations for violations of the laws against monopoly and restraint of trade originate in the publicity given to large earnings per share of stock. Many times the reason for large earnings per share lies not in the taking of extraordinary profits on the product, but in the dividend policy of the corporation. If a large part of the earnings each year is retained and reinvested in the business, the reinvestment per share of stock outstanding may constantly be built up until it reaches large proportions and the earnings per share reflect the earnings of an investment far in excess of even the high market value of the stock.

Remedies for undercapitalization.—The remedies for undercapitalization are comparatively simple. If the surplus is large, stock dividends may be declared to increase the stock outstanding. Stocks with a par value may be split up into a number of shares of lower par value, or they may be exchanged for a number of shares without par value. If the corporation already has stock without par value, a *split* can be arranged, which will give two or more shares for one. Any of these methods will increase the number of shares outstanding and thus distribute the earnings over a greater number of shares. The stockholder will not raise objections to this procedure; in fact, he will welcome it, because it still seems to him that through it he is getting something for nothing, although it should be apparent that his proportionate ownership in the corporation has not been changed in the least.

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Questions for Study and Review

1. Name three duties incumbent upon those responsible for formulating a financial plan.
2. Name and briefly explain four purposes for which a business raises capital.
3. Distinguish between the cost of organizing a business and the cost of establishing a business.
4. Upon what basis should the capitalization of a corporation be determined?
- √ 5. What factors may determine the rate at which the earnings in a given business should be capitalized for the purpose of determining the amount of securities which should be issued?
6. a. State three fundamental rules for the choice of the type of security used in a financial plan.
b. Name four other factors which may act as limitations regarding the choice.

7. Discuss the importance of current styles in the security market as a factor in determining the financial plan.
8. Give six disadvantages of overcapitalization.
9. Give five remedies for overcapitalization.
10. *a.* Name four disadvantages of undercapitalization.
b. How may undercapitalization be corrected?

Problems

1. A careful study of prospects of a new enterprise seems to indicate that the earnings will be \$200,000 and that a return of 20 per cent will be required by investors. What should be the capitalization of the new concern? If it is desired to use no-par stock, what factor will determine the number of shares to be issued?

2. The Atlas Manufacturing Company has just been established. Fixed overhead costs amount to approximately \$80,000 per month. How many units of products must be produced at a selling price of \$25 each, if the directly variable cost is \$15, before a point is reached where all fixed costs are absorbed?

3. A group of experienced automobile men are planning to start a new automobile manufacturing company. It is estimated that the earnings will average about \$400,000. A financial plan is proposed as follows:

6 Per Cent Debenture Bonds.....	\$2,500,000
7 Per Cent Preferred Stock.....	1,000,000
50,000 Shares of No-Par Common.....	<u>2,500,000</u>
	<u>\$6,000,000</u>

Criticize the proposed financial plan.

4. Explain in detail why Mr. Gregory, owning a share of the undercapitalized Company A, par value \$100 and paying regular dividends of 21 per cent, cannot as a rule sell it for as much as he could sell three shares of Company B, par value \$100 and paying 7 per cent, this 7 per cent being a fair return on money at this time, both stocks being equally secure, and both businesses being of the same type.

CHAPTER XIII

Financing Expansion and Selling Securities

Business expansion.—Beside requiring capital for its original establishment, a business frequently requires funds for expansion. Expansion in some cases is merely the result of the ambitions of the principal owners to build a successful venture into an enterprise of large size in the hope of achieving greater profits and, often, greater personal prestige. A concern may find that the demand for its products exceeds its facilities for manufacture, and that it must expand or invite competitors to enter and supply the market. Often, too, the development of machinery to replace hand labor makes possible lower costs, and regardless of any desire on the part of the management to preserve old methods, a new and modern plant must be built to avoid or meet competition. The advantages of quantity production—lower unit costs, broader markets, and greater aggregate profits—represent another reason for expanding a business. Under a given set of circumstances, there probably exists an economical size for any business, that is, a size capable of producing the greatest return per dollar of investment; but such a point is difficult to define even in general terms, and is a practical matter quite often not discovered until too late. However, the purpose of this chapter is not to discuss the economic justification or profitableness of expansion, but to confine itself to the financing of expansion after it has been determined upon, wisely or unwisely, by the management.¹

Expanding by reinvestment of earnings.—Many businesses prefer to grow gradually and normally from the inside; such growth is effected by continually reinvesting in

¹ All students are advised to read the excellent discussion of the underlying motive and economic justification of expansion, in Dewing, Arthur Stone, *The Financial Policy of Corporations*, Chapters I and II, Book V, pp. 693-736.

the business considerable portions of its earnings. This plowing in of profits necessarily reduces the possible dividend payments by exactly the amount put back into the business. Where earnings are sufficiently large to pay the stockholders a fair rate and still have substantial sums to keep in the business, there is usually little objection from the stockholders to this procedure. If, however, the earnings are so small that the reinvestment of a considerable amount cuts the dividend to a very low percentage, or causes it to be passed altogether, stockholders generally object strenuously, and, through threats to replace the directors, often bring about a change in policy.

Financing expansion from the inside avoids the creation of fixed charges which necessarily arise from borrowing funds; it also restricts ownership and control to the original owners without direct call upon them for additional investment. If the stockholders are willing to sacrifice to a considerable extent their dividend payments for several years, they will generally profit both by the increased value of their stock as the company grows in worth, and through the larger dividends they will receive when full dividends are resumed and paid from the larger capital. Whether they will profit more by this method than by selling additional stock or bonds can be determined, if at all, only by a careful study of the particular company under consideration, and of all the conditions surrounding its business. Certainly it can be said that the policy of expanding by internal growth and the reinvestment of profits is at least conservative and safe; although it is generally much slower than other methods, it is a practical example of the pay-as-you-go principle.

Expanding through the use of notes.—Notes are seldom used in any business except for the purpose of some form of temporary expansion. They adapt themselves exclusively to meet short term needs of increased capital for either seasonal, emergency or general expansion purposes. If the management of a corporation uses notes for expansion purposes they will invariably make some provision to fund them as soon as market conditions warrant. Short term notes find no legitimate place in the original financial plan of a new company.

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➤ **Expanding through the use of bonds.**—Bonds often furnish an almost ideal method of raising funds for expansion purposes, especially when such funds are desired for investment in permanent additions or improvement to the plant. They are generally more economical than either notes or stock for the following reasons: the bond interest rate is commonly lower than that on short-term notes; also, it amounts to less than the business earns on the borrowed funds and thus leaves available for dividends to stockholders the difference as an increased earning on their stock, upon the principle of trading on the equity (See Chapter IX); also, the selling cost of bonds is usually smaller than that of stock because the wide market for bonds in large amounts renders the marketing of bonds easier and cheaper than the marketing of stock. It is estimated that on the average the cost of capital raised by long-term bonds is from 1 to 3 per cent lower than that of capital raised by the sale of stock.

Expansion by bonds rather than by stock has the advantage, also, of keeping the control of the corporation in the hands of the old stockholders without additional investment on their part. Bonds can be, and usually are, made for long terms and give the issuing corporation many years in which to prepare to meet them at maturity. This, of course, avoids the embarrassment which often occurs when short-term loans fall due before the assets provided through them have earned enough to pay them off.

In expanding through the sale of bonds it must be carefully borne in mind, just as in original financing by bonds, that their issue creates a fixed charge for interest payments and that, unless there is every assurance that these interest charges can be met year after year, the plan for the bond issue should be abandoned.

Expanding through the use of stock.—The sale of additional stock produces new capital through the bringing in of funds invested in ownership; these funds are termed *owned* instead of *borrowed capital*. It has the advantage that it creates no fixed charges and, if the expanding company should for some years be unable to pay substantial dividends on the increased amount of stock, it is not in danger from foreclosure.

It is expected, of course, that the expansion of the business will bring about such an increase of income that it will be possible to pay on the entire stock, both new and old, dividends equal to or greater than those paid prior to the expansion; but for a certain period, possibly several years, the increased funds may not be fully productive and hence dividends will, in all probability, be temporarily lowered. If such a contingency appears probable, the market price of the company's stock will usually drop, but it will gradually rise again to pre-expansion normality as the earnings grow to the size which will permit the resumption of the former dividend rate.

The sale of new stock divides the ownership of the company into more parts or shares than formerly existed; and if the stock is sold to outsiders, the proportionate interest of the old stockholders is reduced as is, also, their proportionate sharing in dividends. As long as the expanded company is struggling to produce earnings sufficient to pay dividends on the enlarged capital at a rate equal to those formerly paid on its old or smaller capital, this works a hardship on the old stockholders; but when the company has once reached the point where it can equal its old or former dividend rate, this hardship no longer exists. As a matter of fact, the justification for expansion by stock sales is the hope and belief that the company will, through the economies of size, soon be able to surpass its former dividend rate and thus repay the old stockholders for their temporary lessening of income, not only by the increased dividends, but also by the increased market value of their stock.

If, as is often the case, the new stock is bought by the old stockholders in proportion to their respective holdings, then each one still has the same proportionate ownership as before, though he has more funds invested and more shares. This is compensated for, however, as soon as the earnings are sufficient to pay at good rates dividends on the increased stock and thus give all the stock a fair value.

If the additional stock possesses the voting right, the control will be readjusted if the sale is made to outsiders; but, of course, it will remain proportionately unchanged if

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the old stockholders buy the new stock in proportion to their old holdings.

Privileged stock subscriptions.—It is a well-established principle of corporation law that before a new issue of stock may be sold to the general public, the present stockholders must first be permitted to subscribe to the shares in proportion to their holdings. This right does not apply to unissued stock of the original authorization of which the outstanding shares are a part, but to stock subsequently authorized. For example, if a corporation had originally been authorized to issue 100,000 shares of stock, but had issued only 50,000 of them, the subsequent issue of the remaining 50,000 or any part of them would not give rise to a right on the part of the holders of the first issue of 50,000 to subscribe before the stock was offered to the public. If, however, after the original 100,000 shares have been sold, an additional 50,000 shares are authorized and offered for sale, the new stock must first be offered to old stockholders in the proportion of one new share for every two of the old held. This privilege is sometimes voluntarily surrendered by stockholders through a clause to that effect included in the certificate of incorporation.

The legal basis for the right of each old stockholder to subscribe in proportion to his holdings to new issues of stock may be summarized as follows:

1. Each stockholder is entitled to keep his equity in the existing surplus intact.
2. Each stockholder has a right to maintain his proportionate control in the corporation.

Numerous court decisions have established the above principles at law.² The general rule is that the sale of treasury stock does not give rise to the subscription privilege,³ and the company is not usually required to offer new

² See *Stokes v. Continental Trust Co.*, 186 N. Y. 285 (1906), for New York rule on the subject.

³ Where stock has remained in the treasury for such a long period that the control and equities of the outstanding stock may be said to have crystallized, it may be argued that such stock should first be offered to old stockholders before public sale. The general rule, however, does not support this position, but see *Glenn v. Kittanning Brewery Co.*, 259 Pa. 510 (1918).

stocks to old holders of non-voting, non-participating, preferred stock, since these have no voting power and no control over the surplus in the first place; and the corporation may, under certain circumstances, buy property and pay for it by issuing new stock which has not first been offered to the stockholders.

Although the company is not required to place any particular price upon the new stock offered to old stockholders, it must not at some later time offer the same stock to outsiders at a lower price. If the corporation refuses to give a stockholder an opportunity to buy the stock before selling it to others, the stockholder can demand of the corporation that he be permitted to buy and then recover damages. The latter will be measured by the difference between the price at which the stock was sold to others and its market price at the time the company refused to let him buy it.

Although a corporation may offer to bondholders the right of subscribing to stock upon special terms or before offering it to outsiders, bondholders may not claim the subscription privilege as a matter of right, and have no right to a first offering of bonds. Occasionally, bondholders may be given the privilege of converting their bonds into stock on a favorable basis although the bonds when issued carried no conversion privilege.

Stockholders' rights.—The right of a stockholder to subscribe to his proportionate part of any new issues of stock is known as his *privileged subscription right*, but the actual purchasing power attached to each share of old stock is known as *a right*. A stockholder always receives *one right* for each share of old stock held by him, but this right may entitle him to buy varying amounts of the new stock; the amount depending upon the proportionate increase of stocks. These rights are evidenced by certificates issued to the old stockholders by the corporation in proportion to the amount of stock which each one has. The certificate evidencing the possession of one or more rights is commonly called a *warrant*. For example, if the company is increasing its capital stock by 20 per cent, it must give the right to subscribe to one-fifth of a share of new stock for each share of old stock held by the stockholders. Likewise, a 50 per cent increase

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would entitle the stockholders to subscribe to one half a share of new stock for each share of old stock held.

When it becomes known through the announcement of the board of directors of a corporation whose securities are sufficiently distributed to be bought and sold by the public that new stock is to be issued, *trading in* the right usually begins on a "when, as, and if issued basis." The rights are declared to stockholders of record of a certain date, and until that date trading must be carried on as indicated above, for no warrants evidencing the rights have been delivered to the stockholders, and the market price of the stock will include the value of the rights. Further, the announcement of the directors is subject to the decision of the stockholders who must vote on the increase of authorized stock. On or about the record date, the price of the stock is quoted less the value of the right, or, as it is usually stated, the stock sells *ex-rights*. The rights are now traded in separately under the same rules for delivery of the warrants as exist for stock certificates. At the time of announcing the issuing of rights, a date for their expiration is set.

Disposition of stockholders' rights.—With respect to stocks listed on the New York Stock Exchange, the time within which rights may be exercised is limited to fourteen days. A stockholder may *exercise* his *rights* by using them to procure new stock. That is, for every share of new stock which he desires, he turns in the required number of rights and the selling price set by the issuing company. If the stock is increased 20 per cent, the stockholder will receive the right to subscribe to one new share for each five old shares held by him. He will be given a right for each old share held; this right is good for one-fifth of a new share. Thus, if the *offering price* is \$110 per share, he will turn in five rights and \$110, and will receive one new share; or ten rights and \$220 and will receive two new shares; and so on. Since fractions of new shares are not issued, he cannot exercise his odd rights if they amount to less than the number required to procure one new share; but he may sell them to another person to make up a unit, or he may buy enough odd ones to make up another unit for himself. It often happens that the old stockholder does not wish, or is unable, to exercise his

rights by purchasing new stock. In that case, he may *sell* his *rights*, as they are transferable and entitle any holders to exercise them. The proposition of selling his rights brings us naturally to a consideration of their value.

The value of a right.—If a stockholder sells his rights, he will theoretically receive for them an amount equivalent to the loss in value of the old stock held by him. That there will be a loss in value of the old stock will be seen when it is remembered that each share added to the outstanding capital stock of the corporation will add to the assets of the corporation an amount which is less than the value of a share of the old stock before the sale of the new. If this were not true, the right would, as stated above, be worthless.

This theoretical value of the right attached to an old share of stock can be determined by simple arithmetical analysis, or, more readily, by the application of one of a number of simple formulas which have been deduced for the purpose. A formula which is accurate and also easy to apply is the following:

$$P = \frac{M - S}{n + 1},$$

in which P is the value of the right, M the market price of the old stock, S the subscription price of the new stock, and n the number of old shares required to obtain one new share.

To illustrate, let us assume that a company whose stock is worth \$125 a share increases its stock by 25 per cent and gives its stockholders the right to subscribe for new stock at the rate of \$100 a share. Each share held by a stockholder would give him the right to subscribe to one-fourth of a new share, and the theoretical value of this right could be found as follows:

$$\frac{\$125 - \$100}{4 + 1} = \frac{\$25}{5} = \$5.$$

Since for each 4 shares of old stock outstanding (the price of which is \$125 a share), there is sold one new share at \$100, the difference between the price of the old stock and that received for the new (\$125 less \$100, or \$25) is spread over 5 shares, and creates a loss of \$5 in the value of each share. Thus it is seen that the value of the right attached to the old

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share is equal to the loss in value of the old share and, if sold, really amounts to a cash dividend to the stockholder.

When the stock sells *ex-rights* after the record date, its value is, of course, less by the value of one right than when it sold *rights-on*, or, as expressed by traders, *cum-rights*, before this date. This requires a change in the formula used above:

$$P = \frac{M - S}{n}.$$

Assuming the same figures as above, with the stock quoted \$120 *ex-rights*, the result will be:

$$\frac{\$120 - \$100}{4} = \frac{\$20}{4} = \$5.$$

There is a tendency on the part of the stockholder to look upon rights as being in the nature of a dividend, which is evidenced by the usual advance in the market price of the stock in anticipation of rights. As a matter of fact, an issue of new stock accompanied by an offer of rights really offers the stockholder a compulsory choice, either to increase his investment in the corporation or to reduce his proportionate ownership in the corporation through the sale of his rights.

The actual value of the rights.—It is stated above that the theoretical value of the stock after the new stock is issued will be its old price (\$125 less \$5, the value of a New York right), or \$120. As a matter of fact, however, there are several reasons why the stock and the rights will have a value which is different from the theoretical one. If, for example, people decide that the company will be able to maintain the old dividend rate on the increased outstanding capital stock or, possibly, to increase it, the price of the stock after the operation will be as high as it was before, or higher. On the other hand, some stockholders, seeing the natural adjustment downward (which was explained above), may become alarmed, throw their stock on the market, and thus depress the price considerably below its theoretical value.

✓ **Direct and indirect selling of securities.**—When new and additional stock is offered to old stockholders under the privileged subscription plan, there is little for the issuing

company to do other than to mail to the stockholders of record their subscription warrants, together with a circular showing the price and conditions of sale of the stock offered, and then wait till the expiration time of the subscription rights to see how much stock is taken and how much is left to be disposed of to outsiders.

However, when original stock or new stock which is not subject to privileged subscription rights is offered, or when stock with rights which have not been subscribed by old stockholders, or an issue of bonds, is offered, then the issuing company has a serious marketing problem. Occasionally a company will attempt to sell the securities itself, but the great majority have found it more effective to call in the professional security dealer, the investment banker, to handle the sale.

If the sale is to be attempted by the issuing company itself, considerable expense and time will be saved by offering the various securities to the particular class or classes of buyers to whom they appeal. The principal classes of security buyers are as follows:

1. *Stockholders*.—Aside from their pre-emptive right to subscribe to new issues of stock, stockholders are excellent prospects for the sale of new securities, even though the stock offered for sale may not be a newly authorized issue, and, hence, not subject to the stockholders' right of prior subscription. It is quite probable that they will be offered rights to subscribe upon a favorable basis because of the splendid market they provide for the new issue of stock. During the past twenty years, the American Telephone and Telegraph Company has found this method of disposing of its common stock so successful that none has been sold through investment bankers and the company has not deemed it necessary to make agreement with non-holding firms to insure the successful sale of an issue.

2. *Bondholders*.—Bondholders have no inherent right to subscribe to new issues of stock, but are sometimes given the privilege of subscribing to any stock not taken by stockholders. Since, however, a bondholder is usually not interested in stock because of its more speculative char-

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acter, he forms a far better prospect for the sale of bonds. He already is acquainted with the company, and if he thinks well of his first investment, may be persuaded to make another.

3. *Creditors*.—Creditors of the established corporation sometimes buy its securities as a demonstration of their goodwill toward the concern or in order to retain its patronage.

4. *Employees*.—As a general rule, a corporation cannot to any great extent supply its needs for money through the sale of securities to its employees. The practice is frequently found, however, as a profit-sharing scheme in connection with a management policy.

5. *Friends of the management*.—An entirely new corporation has, of course, no old stockholders, bondholders, creditors, or employees; and, therefore, it must rely either upon friends of the management or upon the general public. The degree of success which the new corporation will have in selling its securities to friends of the management will, of course, depend upon two things: (1) the ability of the managers to convince their friends of the corporation's merit, and (2) the wealth of those friends.

6. *The general public*.—After all, it is from the general public that comes most of the investment capital for large enterprises, both new and old. The general public may be divided into classes according to the kinds of securities they buy. They may be grouped as follows:

a. Buyers of pure investment securities: Purchasers who take this kind of securities are those who, although they can buy any kind of security they wish, are desirous rather of owning only such securities as have a ready marketability, a definite minimum rate of income, and great safety of principal. Such securities, of course, yield a low income and usually give their holders little, if any, voice in the management of the corporation.

b. Buyers of legal investments: Certain large classes of security buyers, such as savings banks, trustees, and insurance companies, are restricted by law in their purchases. Securities which they are permitted to buy are known as

legals. The laws relative to legal investments differ in most of the states of this country. *Legal investors* in the State of New York may hold obligations of the United States Government and of certain states and municipalities; they may also hold first mortgages on real estate, under certain conditions; but the only strict business corporation securities permitted to them are first mortgage bonds of railroad companies that have been able regularly to pay dividends on all classes of their stock, and first mortgage bonds of some public utilities. The yield from legal investments is usually even lower than that from those which we have called *pure investments*.

c. Buyers of business men's investments: The third class of security buyers includes those who are willing to take some risk, but who demand a higher rate of income than can be obtained from the purchase of either of the two types of securities mentioned above. The corporation must be substantial, and the outlook for continued and increased earnings must be based upon more than mere chance.

d. Buyers of speculative securities: The fourth class of buyers are those who are willing to assume the risks of investing in securities of corporations with unstable or unproved earnings records and future prospects that are subject to some doubt. The new business in an untried field must of necessity appeal to this class.

It might be added that, from a slightly different point of view, some securities may at the same time be classed by one group of buyers as an investment, and by another group as a speculation; the classification depends upon the economic position and general circumstances of the buyers (See Chapter XVI).

Those companies which decide to offer their securities through investment bankers do not have to worry about classes of prospects, or any other matters. If the companies succeed in making their issues sufficiently sound and attractive for the bankers to agree to take them, the bankers assume the entire selling responsibility. The activities of the investment bankers in the field of selling securities will be discussed in the subsequent paragraphs.

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The investment banker and his functions.—An *investment banking house* is a firm especially organized and equipped to deal in and distribute securities. It has complete executive, investigating, and legal staffs; a permanent selling force; and a large, and more or less permanent, clientele. These houses may be classified as follows:

1. *Wholesalers*, who buy directly from corporations, but do not distribute to private investors.

2. *Large retailers*, who buy from the corporation or from the wholesaler and deal directly with the investors. These may be divided into:

a. *General retailers*, who sell the securities of any corporation, regardless of the industry concerned.

b. *Specialists*, who concentrate their efforts upon certain classes of securities.

3. *Small local retailers*, who have a close but narrow circle of customers.

It is not unusual for a banker in either of the first two large classes mentioned above to do at times the kind of business ordinarily done by the other. While many of these houses will handle various types of securities, there is, nevertheless, a certain degree of specialization among them. Some specialize in bonds, others in stocks; some in government bonds, others in municipals; some in securities of railroads, others in those of public utilities. Industrial corporations will not find many institutions eager to handle their securities in large issues, but there are a few who will handle them if they are of a sufficiently high grade.

Investment bankers make a living by buying securities at one price and selling them at a higher price, in much the same manner as any merchant buys to sell at a profit. Their principal functions are shown below:

1. *Purchase function.*—Most security buyers either are not capable of making an intelligent investigation or are not in a position financially to do so. Yet, they ought never to buy securities until they have assured themselves that the securities have stood the test of thorough and expert

examination. This examination is usually made by the originating banker, through his statisticians or other experts, before he buys the issue for resale to his clients, the investors.

2. *Advisory function.*—The banker advises the corporation as to its financial plan. He decides what kind of securities ought to be issued and when they should be sold. To his clients, the buyers of securities, he gives any information they desire concerning any security whatever. He makes no charge for this service, but it is the best sort of advertising he can do.

3. *Protecting function.*—Most big, reputable investment banking firms will go far to protect their clients by making a market for securities sold to them, by taking an active part in reorganizations, and by supervising the management of weak corporations.

4. *Selling function.*—The selling to investors is done in three ways: (1) by salesmen; (2) by correspondence; and (3) by advertising. Generally all three methods are used in one selling transaction, but probably the chief reliance of the investment banking firm is upon its salesmen. A good security salesman can take a large number of his clients with him if he changes firms, and this, together with the fact that there are always many investment bankers with very much the same type of thing to sell, makes the retail investment bankers peculiarly dependent upon their salesmen.

Listing on an exchange adds to the collateral value and the marketability of a security issue, and for this reason many issues are listed even before they are completely sold.

Advantages of selling through an investment banker.—The profit which the investment banker makes ranges from 1 per cent in the very large, easily sold issues, to 10 per cent in those which are small and somewhat speculative. Few of the big New York houses are willing to handle an issue of less than \$1,000,000, because the expense of selling a small issue is almost as great as that of selling a large one.

There are other organizations whose salesmen sell smaller, more speculative issues for a higher profit by *one call* sales in small quantities.

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The advantages of selling securities through the investment banker are in the main as follows:

1. It assures to the corporation a successful sale within a certain period.
2. The company is relieved of the necessity of organizing a selling campaign.
3. It is usually cheaper to sell through the banker.
4. The corporation receives the advice of the banker regarding the best way to finance.

Regulation of security sales.—There are a number of instances in which the sale of securities is subject to governmental regulation. Railroad corporations engaged in interstate commerce must obtain the approval of the Interstate Commerce Commission before selling securities. Public utility corporations and intrastate railroad corporations are required in many states to secure the approval of state public utility or railroad commissions before they may sell their securities. In addition to these regulations, there are in various states the so-called Blue Sky Laws, which are designed to protect the public against the sale of fraudulent securities and which contain regulations affecting the registration with "blue sky" commissions or similar bodies prior to sale.

The Federal Government assumed control over the sale of securities for interstate distribution or when sold through the mails, whether intrastate or interstate, with the passage of the Federal Securities Act of 1933, under which stringent regulations governing the registration of securities prior to sale were imposed. This act was first administered by the Federal Trade Commission, but the following year, with the passage of a law regulating stock exchanges, this administration was transferred to the Securities and Exchange Commission. The very stringent regulations contained in the first act were somewhat modified the following year at the time that the regulatory authority was transferred to the Securities and Exchange Commission. The Federal regulation of security sales is discussed in greater detail later on in this chapter.

Methods of selling securities with the aid of an investment banker.—The marketing of securities through investment bankers has undergone considerable change of procedure in the last decade from the rather complicated forms of syndicate agreements which imposed various liabilities upon the participants. The distribution of securities on a national basis, coupled with the increased liabilities of underwriters under the Federal securities legislation, has had the effect of greatly simplifying the practice. Where formerly it was quite common for a large investment house to purchase outright an entire issue and then later distribute the risk through the organization of a purchase syndicate, present practice is for a number of large investment banking houses to participate in the original purchase. Formal selling syndicates have been largely superseded by the more informal selling group arrangement described in a subsequent section of this chapter. In marketing securities, some or all of the steps listed below will be used:

1. Underwriting.
2. The purchase group.
3. The selling group.

The underwriting agreement.—The term *underwriting* as used in the business of marketing securities has the same meaning as it has when used in connection with insurance, that of assumption of risk. The *underwriting agreement* is a contract between a corporation and an investment banking concern or group whereby the latter agrees under stipulated conditions to purchase securities, if required by the corporation to do so. A good example is provided by an established corporation issuing new stock which it first offers to its old stockholders. To insure the ultimate success of the sale, should the stockholders not fully respond to the offer, the corporation may make an underwriting agreement with a banker whereby the banker guarantees to purchase any stock not subscribed to by the old stockholders. The term *underwriting* properly used in connection with securities refers not to an initial purchase and sale of corporate securities by an investment banker, but merely to an agreement to purchase

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in the event of certain contingencies. The underwriting agreement usually contains the following provisions:

1. The purpose of the agreement.
2. The recitals of the condition of the company, the amount of the security to be issued, the authorization for the issues, etc.
3. The exact description of the securities.
4. The price.
5. The rate at which the securities are to be sold.
6. The special obligations to the corporation:
 - a. To permit examination of its plants and books.
 - b. To pay expenses.
 - c. To provide miscellaneous covenants which will take care of furnishing needed data, and of appointing and maintaining fiscal agents, etc.
7. The provision that the securities may be rejected if advice of counsel shows them to be illegal.

Objects to be accomplished by underwriting.—An underwriting agreement, such as the one described above, is usually for the accomplishment of any of the following five objects:

1. *Assurance of complete sale of securities for expansion.*—A corporation wishing to market a large issue of stock or bonds for the purpose of financing an expansion cannot take a chance on being able to sell only a portion of the issue and having the entire plan fail. Underwriters will absolutely guarantee the sale of the entire issue at a given price and by a specified time, so that the issuing company, having the perfect assurance that the necessary funds will be provided, may confidently proceed with its plans.

2. *Successful refunding of an issue of securities.*—When a corporation has an issue of bonds falling due, it is frequently desirous of replacing the maturing bonds with others. It therefore offers the new issue of bonds to the holders of the old issue. In view of the fact that the old bondholders have the option of taking either cash or new securities, the operation is rendered safer if bankers will guarantee to pay cash for all the new bonds not taken by the old bondholders.

Their compensation is usually a percentage of the entire issue, regardless of how many bonds they have to purchase.

3. *Promotion of consolidation under the option method.*—As explained elsewhere in this text, the promoter of a consolidation who makes use of the option method first obtains options on the properties which he intends to include in his consolidation, and then forms a syndicate to insure the success of the plan. He now tries to persuade the givers of the options to take, instead of cash in payment for their properties, the securities of the consolidated company. If they refuse to take the securities, the syndicate agrees to take them and to pay for them in cash, which can then be used to take up the options.

4. *Extrication of a corporation from financial distress.*—Occasionally a corporation finds itself in a situation where large amounts of capital are required to enable it to avoid threatened bankruptcy. Its assets may be more than enough to protect a new security issue, and yet it may not be possible to sell such an issue to the public because what little the public knows about the corporation for the time being is not favorable. At such times bankers make a thorough investigation and finally underwrite the new securities. The willingness of the bankers to lend their names to the corporation does much to redeem its credit.

5. *Insuring the success of a reorganization.*—Underwriting syndicates are formed to guarantee the payment by the stockholders or junior bondholders of an assessment required of them before they are allowed to participate in the reorganization of a corporation. The syndicate agrees to pay such assessments as are not paid by the security holders of the old company and to take over their holdings in the new company.

1 **The underwriting syndicate.**—When a group of bankers unite by agreement in sharing the risk of underwriting an issue of securities, the group is known as an *underwriting syndicate*. The entire membership of the underwriting syndicate is not usually a party to the agreement with the corporation. This group comes into being in the following manner. An investment banker, having made an agreement

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to underwrite the securities of a corporation, may desire to share the risk assumed, and will invite a small number of banking firms to participate in the formation of an underwriting syndicate. Each participant in such a syndicate is responsible for taking an agreed proportion of the securities which it may be necessary to take over according to the terms of the underwriting agreement. Sometimes the originating banker, feeling that there is an unusual element of risk involved in the sale of the securities, may not wish to sign an underwriting agreement alone, but merely agrees to act for the corporation in forming a syndicate for the underwriting of the securities, and in such a case the syndicate members all become parties to the original underwriting agreement.

The purchase of securities.—In most instances, the investment bankers may purchase an issue of stock or bonds outright. Bonds are almost always sold by the corporation in this manner, for it is quite unusual to offer bonds to old security holders before attempting public sale. In such a case, the investment bankers make an agreement to purchase at a given price an issue of bonds or stock. The purchase agreement with the corporation will usually cover such items as the following:

1. A detailed description of the securities and the purpose for which they are being sold.
2. The price at which securities are to be sold to the bankers and the price at which they are to be offered to the public.
3. An agreement by the corporation to meet Federal and state requirements precedent to the sale of the securities.
4. A statement of the time when the banker must pay the corporation for the securities. Sometimes this provides for full payment at the time the agreement is signed, and sometimes payment is to be made in installments.
5. A statement providing for an audit by independent auditors to be paid for by the corporation.
6. An agreement by the corporation to have its books audited once a year by a firm of public accountants.

7. An agreement by the corporation that the bankers shall be represented on the board of directors.

8. A statement in which the corporation agrees to have the bankers' legal counsel prepare or approve all papers necessary for the issuance of securities, for example, the authorization by the stockholders.

9. A reservation on the part of the bankers to cancel the agreement should legal counsel hold the issue illegal.

10. Any other provisions which may be necessary for the protection of the rights of the parties.

The purchase group.—As previously noted, while a corporation desiring to sell securities will usually approach one house which is afterwards known as the originating house, the actual purchase is usually divided among several large investment houses known as the purchase group. The members of the purchase group are considered as underwriters under the provision of the Federal Securities Act and are, therefore, subject to the liability imposed by this Act up to the amount of the purchase participation. Accordingly, they, too, may join the originating investment bankers in the investigating of the securities to be offered for sale. The originating banker usually acts as a manager of the purchase group, and in all probability will continue as manager of the selling group to be formed later. Members of the purchase group usually agree to assist in supporting the market during the period of distribution. This may be accomplished by having each member of the group agree to take up a certain proportion of additional bonds that the manager of the group may repurchase in connection with the maintenance of the selling price, at the offered price. The originating banker receives compensation for his work in an allowance of a small percentage of the spread between the purchase price and the offering price.

Selling groups.—In recent years, the distribution of securities has been on a national basis, and an arrangement whereby the retailers of securities may avoid the usual underwriting liabilities has been necessary. The selling group is made up of dealers who express an interest in the issue to

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the extent of being willing to make an outright purchase of securities. Their compensation is a profit on the securities they sell. An agreement with the members of this group usually contains: (1) a provision that the selling price to the investor must be maintained until a certain date, usually 60 days from the date of the agreement; and (2) a provision that any securities sold by a member and which must be repurchased by the managers in the open market may be returned to the group member originally selling the securities at cost. This is necessary if the manager is to function properly in supporting the market for the benefit of the group as a whole. It is quite usual for the purchase group members to retain a large proportion of the securities and thus participate in the additional profits gained through retail sales. Under the Federal Securities Act, underwriters are not permitted to sell the new securities until twenty days after the registration statement has been filed.

The group manager.—Reference has been made in the discussion to the various duties of the banker who occupies the position of group or syndicate manager. It is quite usual for the same banking concern to act as manager for not only the purchase, but also the distributing, groups. The manager, by the terms of the various agreements, is given practically unlimited power to act for the members. His duties may be summarized as follows:

1. To make the original investigation.
2. To advise the corporation or other obligor concerning its securities and financial plan.
3. To write and execute the underwriting or purchase agreement.
4. To select the participants.
5. To draw up the purchase group agreement.
6. To market the securities. (Sometimes this is done by the corporation or other issuer of the securities without his help; sometimes, by him alone; and frequently, by him and the participants under his management.)
7. To support the market.
8. To keep the accounts.

9. To make calls or negotiate loans.
10. To distribute the unsold securities among the members of the purchase group.
11. To divide the profits or to apportion the losses.

The cost of selling securities.—There is no standard charge or cost to corporations selling securities through investment bankers. Conditions in the financial markets, the type of security, the business in which the corporation is engaged, the financial standing of the corporation, and many other factors will govern the amount of compensation allowed to the banker. In 1934 the Chesapeake Corporation announced an issue of \$18,000,000 ten-year 5% convertible collateral trust bonds which were to be offered for sale to the public by bankers at 101 per cent and accrued interest to date of delivery. The price to the bankers was established at 98 per cent and accrued interest to date of delivery, which provided for a three-point spread between the price to the banker and the price to the public, from which both the purchase and selling groups were to obtain their compensation. It was further stated that the selling group was to receive the bonds at 101 per cent less $1\frac{3}{4}$ per cent, which would give the selling group a compensation of $1\frac{3}{4}$ per cent. However, out of this amount, the purchase group was allowed to retain not in excess of $\frac{1}{4}$ of one per cent for the pro-rata share of any expenses incurred in connection with the issue. It may be seen, then, that the net proceeds of the issue to be received by the corporation from the bankers will be \$17,640,000, making the cost of the financing \$360,000.

Where the agreement is merely to underwrite an issue of stock for an established company and the stock is being offered first to the old stockholders, the bankers receive a low rate, perhaps 1 per cent, on all stock taken by the old stockholders, and a larger amount, say from 2 to 5 per cent, on such stock as the underwriters may be compelled to take over. The general rule is that the more difficult the bankers feel that it will be to sell an issue, the more highly they must be compensated.

Federal security regulations.—The Federal Securities

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Act of 1933, as amended in 1934, and the Securities and Exchange Act of 1934 make very definite requirements for the registration of security issues before sale. The registration statement must contain information on the general organization of the corporation, the distribution of voting power, a summary of the corporation's history and the description of its business, a full description of the properties, and full details of all capital issues, including the issue presently offered. The relationship between officers and directors of the issuer and the underwriters and the trustees also, if a bond issue is to be made, complete details with regard to the underwriting agreement, and details with regard to the application of the proceeds from the financing. In addition to these requirements, the Securities Act makes directors, officers, accountants, and underwriters liable for misstatement of material facts, any omission of required statements, and misleading omissions in the registration statements. The penalty to which they may be subjected will be damages for loss to the investor represented by depreciation in value of his security as a result of such errors or omissions in the registration statement. This liability is joint and several with a right of contribution against any person who, if sued separately, would have been liable. However, the right to recovery is limited to three years. The original Act exempted all but the issuer from liability provided they were able to prove that after *reasonable investigation* they had reasonable ground to believe, and did believe, that the statements contained in the registration statement were true and that there were no material omissions. In 1934 the liability of all persons with the exception of the issuer was further modified so that such persons would not be liable if he had no reasonable ground to believe and did not believe that statements contained in the registration statement purporting to be made on the authority of an *expert* were untrue or that there were material omissions.

Devices used as an aid in marketing bonds and preferred stock.—

1. *Stock as a bonus.*—Sometimes, in order to sell preferred stock, a share of common stock, usually stock without

par value, is given as a bonus. This method is usually employed on a so-called *unit* basis. For example, with each two shares of preferred stock purchased, the purchaser receives a share of common stock as a bonus. In April, 1925, in the financing of the Dodge Brothers, Inc., one share of Class A non-voting common stock was given with each share of \$7 cumulative preferred stock which was sold by the bankers at \$100 a share. Instances of the use of stock as a bonus to aid the sale of bonds are rare, the device frequently used being that of stock purchase warrants, to be described subsequently.

2. *Conversion*.—In order to lend marketability to an issue of bonds and also to provide for their eventual retirement, the privilege of converting the bonds into stock may be used. This device gives to the bondholder an opportunity to participate in the earnings of the company should he at some later time choose to do so. The subject of convertible bonds has been treated in detail in Chapter XI.

3. *Stock purchase warrants*.—A stock purchase warrant is an option given by a corporation to the warrant holder to purchase under specified conditions of time, price, and amount some security of the corporation, usually common stock. In recent years, warrants have been frequently used as a means of facilitating the sale of preferred stock and bonds. The corporation using warrants in this manner gives to each purchaser of a bond or preferred stock warrants which are, in effect, options to purchase stock under certain conditions of time and price, which will be described in the following paragraph.

Characteristics of warrants.—Warrants, like stocks and bonds, vary greatly in the provisions and covenants which they contain. The chief provisions are those concerning the price at which they may be exercised and the time over which the option extends. In regard to these features, warrants may be divided into four main classes:

1. The *straight perpetual* warrant provides that it may be exercised at a certain fixed price at any time as long as the issuing company exists.

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2. Some warrants are exercisable at a *fixed price*, but the time for exercising is *definitely limited*.

3. Another variety provides for a *progressive* price increase as the exercise is deferred from one period to another. An example is the issue of the debentures of the North American Gas & Electric Company, which carried warrants entitling the holder to buy two shares of common stock for each \$100 of debentures as follows: at \$20 per share to January 2, 1931; at \$25 per share to January 2, 1933; and at \$30 per share to January 2, 1934, at which time all warrants not exercised became void.

4. A fourth type of warrant has stock prices *graduated* upon *priority of exercise* rather than upon any specific periods of time. The Central States Electric Corporation's debentures, for example, carried warrants entitling the holder to purchase on or before September 15, 1934, 10 shares of common stock priced as follows: at \$89 per share for the first 62,500 shares purchased; \$94 per share for the next 62,500 shares purchased; and \$104 per share for the next 62,500 shares purchased.

Most warrants provide for the possibility of a change in the financial set-up of the company by a provision to the effect that if, during the life of the warrants, the stock of the company shall be *split* into a greater number of shares or consolidated into a smaller number of shares, then the number of shares purchasable under the warrants shall be increased or decreased accordingly.

Provision is also usually made to cover the contingency wherein the issuing corporation may consolidate or be merged with another company or several companies. The usual provision is that the equitable purchase rights of the warrant holders in shares of the consolidated or merged company shall be made a part of the terms of the consolidation or merger agreement.

Some warrants provide that the stock purchased under their options shall be paid for in cash; others provide that stock can be obtained only by the surrender of the security with which the warrant was originally obtained; still others give the warrant holder an option between these two methods

of payment. There are a few instances in which the warrant gives the holder the option to purchase stock in another corporation. There are, also, rare instances in which the issuing company reserves the right to *call* the warrants at a specified price.

After much misunderstanding and argument on the subject, a decision has been handed down, in the case of *Van-Allen v. Illinois Central R. R. Co.* (7 Vos. 515), that while stock purchase warrants are assignable, they are not negotiable.

Warrants may be made detachable or non-detachable. The non-detachable warrants may be exercised only by the holder of the bonds or preferred stock to which the privilege was originally attached. Detachable warrants, on the other hand, may be sold by the security holder and exercised by anyone in possession of the warrant itself. Warrants are not always used in connection with an issue of bonds or stock. They are sometimes issued in the form of *stock options* to be given to bankers and promoters as compensation for their services, the services rendered in such a case being the *consideration* for the giving of the option. It may be seen, too, that the possession of a stock purchase warrant for the purchase of voting stock in sufficient quantity provides a means of maintaining potential control of a corporation without actually making an investment of funds.

Financing the small company.—Strange though it may seem, the small company is usually much more difficult to finance than the large one. The very small enterprise is usually an individual proprietorship financed only by the personal wealth of the owner and by what loans he is able to procure on his personal credit. Most small proprietors have small wealth and little credit, and their businesses often suffer for lack of sufficient capital.

Partnerships, both general and limited, are in a better position to finance themselves, because if sound, they can continue to take in additional partners with cash and credit.

Small stock companies and corporations which depend for capital upon the sale of their securities to the public are, as a rule, particularly difficult to finance. They cannot obtain the services of investment bankers, because the total of

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their issues is too small to be handled profitably by these houses. Very few banking houses can be induced to handle any issue of less than a million dollars. The small issues cost practically as much to investigate, advertise, and market as do the larger ones, and the rate of commission is so low that on small issues all margins are eaten up by costs. The issuing company, therefore, has to attempt to sell its own securities. The organizers generally work among their relatives, friends, and business acquaintances; frequently employ independent salesmen; and often seek assistance through newspaper and magazine advertisements, and through direct mail solicitation. If the proposition is thoroughly sound, the securities can generally be disposed of, but only with great difficulty and at a large expense as compared with the easy disposal of large issues through the channels of the investment banks.

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Questions for Study and Review

1. Discuss the expansion of a business by means of the reinvestment of its earnings.
2. Discuss the expansion of a business by means of the issuance of bonds.
3. Discuss the expansion of a business by means of the sale of additional stock.
4. *a.* Define and describe a stockholder's privileged subscription right.
b. Tell why the law requires corporations to offer this privileged subscription to old stockholders.
c. Give and explain a formula for finding the value of a right.
5. *a.* To whom may a corporation sell its securities?
b. Classify the general public according to the types of securities it buys.

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6. *a.* What are the functions of an investment banker?
b. What are the advantages of selling securities through an investment banker?
7. How are security sales regulated?
8. *a.* What points are covered by an underwriting agreement?
b. What objects may be accomplished by underwriting?
9. *a.* Describe a purchase agreement.
b. What power does it give the manager?
c. What is the work of a group manager?
10. What is a warrant? How do warrants facilitate the sale of securities?
11. Describe four variations of warrant provisions concerning the price at which they are exercisable and the length of time of their option.
12. What is the difference between a detachable and a non-detachable warrant?
13. Explain the statement that a small company is usually more difficult to finance than a large one.

Problems

1. The balance sheet of the XYZ Corporation appears as follows:

ASSETS:		LIABILITIES	
Cash.....	\$ 50,000	Notes Payable.....	\$ 150,000
Notes Receivable.....	40,000	Accounts Payable...	100,000
Accounts Receivable..	200,000	Accrued Liabilities...	30,000
Inventories.....	200,000	1st Mortgage 5%	
Investments.....	50,000	Bonds.....	300,000
Land, Building, and		Capital Stock, 5,000 at	
Equipment.....	800,000	\$100 par.....	500,000
Patents, Trade-Marks,		Reserves.....	70,000
etc.....	100,000	Surplus.....	400,000
Treasury Stock.....	100,000		
Deferred Charges.....	10,000		
	\$1,550,000		\$1,550,000

a. Assume that A owns 500 shares of the capital stock and \$30,000 par value of the bonds of the company. The company in-

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creases its capital stock by \$100,000. A syndicate offers to buy all of the stock at \$110 a share. All of the stockholders except A agree to the offer of the syndicate. A objects. Later the company sells to the syndicate all the new stock at \$110. Immediately thereafter the stock is quoted at \$125 a share. What rights has A? (*Stokes v. Continental Trust Co.*, 186 N. Y. 285.)

b. If the company had merged with another corporation and had given the new stock in exchange for the stock of the other corporation, would A have had any right to subscribe to the new stock?

2. a. In May 1937, the Inland Steel Company gave to its stockholders the right to subscribe at \$90 for new stock in the proportion of one share for each twenty shares held. The stock was selling in the market at 114. What was the value of the right?

b. What disposition could a stockholder have made of his rights, or how could he have *cash*ed his privilege?

c. Contrast with a fraudulent prospectus a circular issued by a conservative investment banker.

3. Find the value of a right in each of the following issues, and in each case tell how many rights are required to procure one share of the new stock:

	<i>Number of Old Shares</i>	<i>Number of New Shares</i>	<i>Market Value of Old Share</i>	<i>Offering Value of New Share</i>
(a) Company A	1,000	200	\$110	\$103
(b) Company B	3,000	1,000	109	100
(c) Company C	4,000	2,000	120	110
(d) Company D	6,000	1,000	115	103
(e) Company E	5,000	1,000	100	100

4. a. Explain how stock is sold with the aid of an underwriting syndicate.

b. What methods of raising additional capital may be employed by a successful going business too small to make use of an underwriting syndicate or investment house.

5. The Andrews Woolen Mills, Incorporated, has sold and has outstanding 7,000 shares of its 10,000 authorized shares of \$100 par value stock. It is prosperous, having average annual net earnings of \$150,000. It has no bonded indebtedness. The directors are anxious to enlarge and expand, but desire to issue bonds and to trade on the equity rather than simply to sell the remainder of the authorized stock. On account of a long-con-

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tinued bull market on stocks, there is practically no market demand for bonds. Devise a plan which will enable the company to dispose profitably of \$500,000 of bonds.

CHAPTER XIV

Financing Working Capital Requirements

The nature of working capital.—In practically every business the assets may be divided into two divisions: *fixed* and *current*. *Fixed assets* are ordinarily the land, buildings, fixtures, and equipment of the concern which are acquired not for resale but for use in the conduct of the business. They are generally thought of as being permanent; that is, they function as productive instruments over a long period of time. *Current assets*, while they may vary somewhat in different lines of business, are usually made up of cash, accounts and notes receivable, inventories, and occasionally other assets such as marketable securities held as a temporary investment of surplus cash.

The primary distinction between the fixed and current assets is that the fixed assets are, for all practical purposes, permanent or fixed in character, while the current assets constantly change in form. At one moment a certain portion of the current assets may be in the form of cash. The cash may be expended for raw materials; it thus creates an asset of inventory to take its place in the balance sheet. Raw materials inventory plus the other costs of manufacture becomes finished goods inventory. If the finished goods are now sold, the form of the asset is changed once more, perhaps again to cash or possibly to accounts or notes receivable. The change depends upon whether the sale is for cash or on credit. It may be seen that in a going business the condition of the current assets is not static. The capital invested therein represents a sort of revolving fund starting with cash which is used to pay for raw material, labor, and other operating expenses and which is to be recovered again through the sale of the finished product.

The capital invested in the fixed assets is ordinarily re-

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ferred to as the *fixed capital*, while that invested in the current assets is termed *working capital*. In other words, *the sum of the current assets is the working capital of a business*. In showing the distinction between fixed and current assets, the early and eminent economist John Stuart Mill uses the term *circulating capital* to describe the current assets.¹ The term is an apt one, for it connotes exactly what the business man means when he speaks of working capital. The following simple balance sheet will serve to illustrate the various asset and liability relationships:

¹ John Stuart Mill, *Principles of Political Economy*, pp. 91-92 (Longmans, Green and Co., New York, 1923).

"Of the capital engaged in the production of any commodity, there is a part which, after being once used, exists no longer as capital: is no longer capable of rendering service to production, or at least not the same service, nor to the same sort of production. Such, for example, is the portion of capital which consists of materials. The tallow and alkali of which soap is made, once used in the manufacture, are destroyed as alkali and tallow; and cannot be employed any further in the soap manufacture, though in their altered condition, as soap, they are capable of being used as a material or an instrument in other branches of manufacture. In the same division must be placed the portion of capital which is paid as the wages, or consumed as the subsistence, of laborers. The part of the capital of a cotton-spinner which he pays away to his work-people, once so paid, exists no longer as his capital, or as a cotton-spinner's capital; such portion of it as the workmen consume, no longer exists as capital at all; even if they save any part, it may now be more properly regarded as a fresh capital, the result of a second act of accumulation.

"Capital which, in this manner, fulfills the whole of its office in the production in which it is engaged by a single use, is called *Circulating Capital*. The term, which is not very appropriate, is derived from the circumstance that this portion of capital requires to be constantly renewed by the sale of the finished product, and when renewed is perpetually parted with in buying materials and paying wages; so that it does its work, not by being kept, but by changing hands.

"Another large portion of capital, however, consists in instruments of production, of a more or less permanent character; which produce their effect not by being parted with, but by being kept; and the efficacy of which is not exhausted by a single use. To this class belong buildings, machinery, and all or most things known by the name of implements or tools. The durability of some of these is considerable, and their function as productive instruments is prolonged through many repetitions of the productive operation. In this class must likewise be included capital sunk (as the expression is) in permanent improvements of land. So, also, the capital expended once and for all, in the commencement of an undertaking, to prepare the way for subsequent operations: the expense of opening a mine, for example; of cutting canals; of making roads or docks. Other examples might be added, but these are sufficient. Capital which exists in any of these durable shapes, and the return to which is spread over a period of corresponding duration, is called *Fixed Capital*."

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JOHN DOE MANUFACTURING COMPANY

Balance Sheet, December 31, 19—

Cash\$20,000 Notes Receivable..... 1,000 Accounts Receivable.... \$ 5,000 Less Res. for Bad Debts 150 4,850 Inventories: Raw Materials.....\$ 9,000 Work in Process..... 3,000 Finished Goods..... 8,000 20,000 Total Current Assets \$45,850	Notes Payable.....\$ 8,000 Accounts Payable..... 10,500 Accrued Payroll..... 2,000 Total Current Liabilities \$20,500 First Mortgage..... 14,000 Common Stock..... 20,000 Surplus..... 12,350
Land..... 8,000 Buildings.....\$10,000 Less Res. for Deprec. . . 3,000 7,000 Machinery and Equipment\$10,000 Less Res. for Deprec. . . 4,000 6,000 <u>\$66,850</u>	<u>\$66,850</u>

It is important to note that it is the purpose to be served by the assets, as well as their nature, which characterizes them as working capital. The sources from which may come the funds for the acquisition of the assets is immaterial. Working capital may come from long- or short-term borrowings, from contributions of the owners, from profits left in the business, or from the sale of fixed assets no longer needed as such. Any acquisition of funds which increases the current assets increases the working capital, for they are one and the same.

Net working capital.—Working capital has often been defined as “the excess of current assets over current liabilities.” This definition is erroneous. Should it be accepted, it would mean that working capital could be obtained ordinarily in but three ways; from the owners in the shape of capital contributions, from long-term borrowings, and from undistributed profits. In a corporation this would mean that working capital could arise from the sale of stock, from the sale of bonds, and from accumulated earnings. Other sources would increase the current liabilities by the same amount as the increase in current assets; hence, the working capital remains the same. Business men do not so limit the meaning of the term, for, as pointed out in the

preceding paragraph, it is primarily the purpose to be served by the asset and not its ultimate ownership which distinguishes it as working capital. Much difficulty could be avoided if, for the excess of current assets over the current liabilities, the term *net working capital* would be used. Fortunately this term is fast gaining favor in modern financial parlance.²

Necessity for working capital.—The best equipped factory in the world would not be able to begin operations without some capital above that invested in buildings and equipment. Additional funds must be contributed or borrowed by the owners before business can be carried on. Funds are needed to pay for raw materials, for wages, and for other operating expenses. Normally, considerable cash must be expended before goods are delivered to customers and cash is returned to the business. Concerns wealthy in fixed assets often fail because of lack of foresight in planning for sufficient current funds to take care of the ordinary needs of the business. In the organization of a new business, the provision for working capital is an important feature of the financial plan. In an active business the adequacy and the turnover of the current assets is always a matter of concern to the treasurer.

Regular and special working capital.—This classification of working capital is a convenient one because it indicates the purpose to be served by the funds acquired for investment in the current assets. A business always needs a certain amount of assets in the form of working capital if it is to carry out its function as a going concern. The amount which it is deemed proper to carry in this form, month in and month out during the year, is the *regular working capital* of the business. At certain times, however, a greater amount of working capital may be required. Seasonal needs such as the necessity of financing large purchases of raw material or a large volume of business, or sudden emergencies calling

² This point of view is taken in this chapter notwithstanding the fact that the publishers of several well-known statistical manuals of corporation reports list as working capital that portion of the assets which we choose to term *net working capital*.

for additional funds, give rise to a need for *special working capital*. The distinction between the two is merely the fact that special working capital indicates the amount by which the current assets have of necessity been expanded above the natural requirements of the business, while regular working capital indicates the amount it is deemed expedient to keep, as a regular requirement, in the form of current assets.

The cash position.—Many persons use the term *cash position* to mean the same thing as working capital. The terms are not synonymous. The *cash position* of a business is expressed by the ratio of cash on hand and in banks to bank loans. There is no standard, although the usual requirement of the banks that bank balances equal about 20 per cent of the bank loans suggests that the ratio should at least approximate this figure.

The quick ratio.—Another ratio used in testing the current position of a business is the ratio of cash plus receivables to current liabilities. This ratio is known as the *quick ratio*. As in the case of the current ratio, there is no general standard. It must be used with a view to the circumstances, the type of business, the season, and a great variety of factors which may affect it.

The current ratio.—The ratio of the current assets to the current liabilities is known as the *current ratio*. This ratio is often used to test the adequacy of working capital. In fact, it is often erroneously stated that the adequate current ratio should be two to one; that is, that the current assets should be at least twice the current liabilities. No such standard can be established. The current ratio is not a test of the adequacy of working capital. It merely indicates the extent to which the current assets may decline and still be sufficient to take care of the current liabilities. It will vary according to the type of business. A concern which has a rapid turnover of its current assets will usually require a smaller excess of current assets over current liabilities than one with a slower turnover. But in practice the current ratio shows a wide variation, as illustrated by the following examples:

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<i>Company</i>	<i>Current Ratio^a</i>				
	<i>1933</i>	<i>1934</i>	<i>1935</i>	<i>1936</i>	<i>1937</i>
American Can Co.....	3.60	3.55	3.45	3.12	2.63
American Woolen Co., Inc.....	5.61	43.27	9.87	4.28	31.18
DuPont de Nemours & Co.....	8.87	6.47	6.38	4.80	5.59
Swift & Co.....	8.28	7.65	6.28	6.13	7.24
United Fruit Co.....	5.45	5.58	5.54	5.59	5.48
United States Steel Co.....	7.75	7.50	6.45	4.68	4.10
Brooklyn Union Gas Co.....	2.28	2.29	2.09	2.11	1.56
Detroit Edison Co.....	2.54	2.50	2.18	1.89	1.40

In comparing similar businesses or in contrasting present conditions with those in the past, the ratio has value; but it should not be assumed that a standard can be established which is applicable to all types of business. In determining the amount of working capital a concern should have, many factors must be given consideration; these same factors rather than the current ratio are to be weighed when testing the adequacy of working capital in a going concern.

Factors affecting working capital requirements.—No definite rule can be established for determining the working capital requirements of a business. A business should always have enough of a margin of current assets over current liabilities to make sure that it can pay its bills as they come due. How large this margin should be depends on many factors. It has been shown that the requirements of a business in this respect are not always the same. They vary not only from year to year, but also from month to month. The requirements vary, also, depending on the type of business; and in order to determine the proper amount of working capital a concern should have, careful consideration should be given to the following factors:

1. General type of business.
2. Turnover of receivables.
3. Turnover of inventories.
4. Relation of the terms of purchase and sale.
5. Seasonal variations in the industry.
6. Normal rate of expansion in the volume of business.
7. Banking connections.

^a Standard Corporation Records 1938, Standard Statistics Co., Inc., New York.

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A brief discussion of these factors may help to show their importance.

1. *The general type of business.*—If the business is one dealing in staple products such as the necessities of life, demand is likely to be uniformly steady in periods of general business depression, as well as in periods of general prosperity. The inflow of cash at all times will probably be sufficient to take care of current liabilities, and there will be required a smaller margin of working capital over the amount of current liabilities. The same is true of most public utilities, largely for the same reason. Their services are always in demand and, also, are usually on a cash basis. Their income generally comes in with sufficient regularity to meet the current liabilities as they become due; thus such businesses do not require a large reserve of net working capital.

2. *Turnover of accounts receivable.*—The turnover of accounts receivable or the average time during which accounts are unpaid depends almost entirely upon the terms of sale. In periods of business depression, turnover of accounts receivable often is slowed up because of difficulties in collecting bills. Terms of sale in different lines are often dictated by custom and are hard to break; if these are long, it means that a large part of the current assets may be tied up in customers' accounts. Accounts receivable turnover, therefore, becomes an important factor in estimating the amount of working capital a concern should have. The turnover of accounts receivable outstanding may be ascertained through the use of two simple formulas:

$$\text{Accounts receivable turnover} = \frac{\text{Credit sales for period}}{\text{Average accounts receivable outstanding}}$$

$$\text{Average length of period of accounts receivable outstanding} = \frac{360 \text{ days}}{\text{Accounts receivable turnover}}$$

3. *Turnover of inventories.*—Inventories in a retail, jobbing, or wholesale establishment usually are of one kind finished goods in a marketable state. In the case of a manufacturing establishment, however, inventories are of three kinds: first, inventories of the raw material to be

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consumed in the manufacture of the product; second, the goods or work in process, the value of which is made up of the cost of raw material used plus the labor and expenses incurred up to the date of taking inventory; third, the finished goods which represent the amount of completed products on hand. Inventories should be carried on the books at cost or market price, whichever happens to be lower.

In a manufacturing concern, turnover must be computed on each of these inventories; and in so doing, the following formulas are helpful:

$$\text{Raw material turnover} = \frac{\text{Amount of goods going into process during the period}}{\text{Average raw materials inventory during the period}}$$

$$\text{Work in process turnover} = \frac{\text{Amount of work in process transferred to finished product}}{\text{Average work in process inventory during period}}$$

$$\text{Finished goods turnover} = \frac{\text{Cost of goods sold}}{\text{Average finished goods inventory at cost}}$$

Probably no factor is so important in most cases from a working capital standpoint as the turnover of inventories. Inventories are usually the least liquid of current assets; and they are subject to price depreciation, to deterioration and other hazards. A concern that has a large inventory and that is going into a period of business decline, accompanied by a falling of prices, faces a serious working capital problem. The large mail order houses and businesses in similar lines faced just such a problem during the decline which took place in 1920-1921. Indeed, so sharply did prices fall that the problem had to be faced, also, by business generally.

Sometimes the very nature of the business is such that inventories are large and turnover is slow. This is true, for instance, of the leather manufacturing business, where the process period is very long. Businesses having slow inventory turnover are likely to have a proportionately larger amount of their cash tied up in inventories; since this item is large, more working capital is required in the form of

cash and accounts receivable in order to meet the current liabilities as they come due.

4. *Relation of the terms of purchase and sale.*—If the terms on which goods are purchased correspond closely to the terms of sale, receivables are liquidated as bills come due. This is of particular significance in a business where purchases of raw materials constitute the main cost of doing business. When this is the situation and goods are purchased on credit, those from whom the goods are purchased are financing the carrying of the accounts receivable. Since trade credit is one source of working capital, the amount of working capital is increased directly as the amount of accounts payable is increased. If, however, it is desired to take advantage of cash discounts (thereby greatly reducing the accounts payable), the amount of working capital may have to be increased in order to accomplish this purpose, especially if the selling terms are long and the turnover of receivables is slow.

5. *Seasonal nature of the business.*—A business which has a decided seasonal trend will require more working capital at one season than another. During the selling season, or shortly thereafter, when receipts are coming in rapidly, current payables can be liquidated out of receipts. During the period prior to the season of active demand, stocks must be purchased for resale; and in manufacturing businesses it is often found that manufacturing operations must be increased two or three months in advance of actual sale. This means that most of the ready cash of the concern will be tied up in inventories and receivables; in fact, it is quite possible that additional working capital must be obtained in the form of bank loans to carry the business over the peak periods. During slack seasons, there may be an excess of working capital in the form of cash which must be profitably employed outside the business.

6. *Normal rate of expansion in the volume of business.*—Care should always be exercised to see that the additions to net working capital correspond to the needs of an expanding business. There are times when inability to obtain additional working capital in the form of bank or trade credit means that further business cannot be taken. It is always

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wise when planning to obtain working capital to have an eye to future as well as present needs.

7. *Banking connections.*—A concern which has established substantially good banking connections and enjoys the confidence of commercial bankers may rely on obtaining a large amount of working capital in this way. This does not mean that the concern may depend entirely upon bank loans to supply its working capital, but rather that it does not have to maintain quite so large a margin of regular working capital above the current liabilities. In other words, good banking connections may reduce the amount of regular working capital which must be obtained from other sources, for should the latter prove inadequate to meet some temporary or seasonal needs, bank loans may be relied upon to cover these requirements.

✓ **Sources of working capital.**—The various sources of working capital require some explanation as to their suitability and the problems they involve. It should be remembered that anything that increases the amount of current assets is a *source of working capital*. A list of the most important sources follows:

A. Long-term sources.

1. Capital invested by the owners (sale of stock, etc.).
2. Long-term borrowing (sale of bonds, etc.).
3. Accumulated profits invested in current assets.

B. Short-term sources.

1. Trade credit in the form of—
 - a. Accounts payable.
 - b. Notes payable.
 - c. Trade acceptances.
2. Bank loans—
 - a. Unsecured.
 - b. Secured by collateral.
3. Bankers acceptance.¹
4. Sale of commercial paper in the open market.

Working capital from long-term sources.—A large part of the working capital of a business should come from *long-term sources*. No concern may safely depend for any long

¹See Chapter XVII.

period of time upon bank loans and other short-term sources of working capital. There may be times when bank loans are difficult to renew and trade credit is grudgingly extended. This is often the case in times of business depression. When the latter has been preceded by a severe price deflation, as in 1920-1921 and 1930-1931, a concern which has depended largely on short-term sources may find itself in desperate straits through having to reduce its bank loans and trade debts from the sale of inventories that have greatly depreciated in value.

Businesses which originally have sufficient working capital provided from long-term sources often fall into the error of neglecting to provide additional long-term working capital to cover the needs of expansion. As a concern grows, it needs more working capital to take care of the needs of a larger volume of business. Another mistake that is often made is to invest cash needed for working capital in fixed assets, relying on bank loans to replenish the cash. As such procedure is equivalent to borrowing on short term for permanent capital purposes, it is likely to get the firm into difficulty at some later time when the loan is called.

As to the amount or proportion of working capital to be obtained from long-term sources, it should be clear that no definite standard can be established. There should always be a safe margin above the usual amount of current indebtedness. How much this margin should be must be judged from a study of all the factors affecting working capital requirements in general.

Public utilities, until recently, were not concerned over the relationship of their long-term working capital and their current indebtedness. This is because, having a ready market for their securities, they could readily *fund* the current indebtedness at any time.

There is no need for discussion here of the principles to be followed in raising working capital through the sale of stock or bonds. The raising of capital by these methods has been discussed in previous chapters. A word or two, however, with regard to accumulating profits for working capital purposes may help to make this point clear. Earnings which are not paid out in dividends are usually invested or *plowed*

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back into the business. As such, they may be invested in either fixed or current assets. When invested in the latter, they constitute part of the working capital. Occasionally, a part of the surplus is definitely earmarked as *reserve for working capital*; this procedure, however, is not necessary except as a psychological measure to prevent stockholders from clamoring for the disbursement of the surplus in the form of dividends.

A corporation wishing to retain a part of the surplus permanently in the business may easily do so by declaring a stock dividend which definitely transfers a portion of the surplus to the capital account. This procedure is discussed in detail in the chapter on "Surplus, Dividend, and Reserve Policies."

Short-term sources of working capital.—Practically all businesses make use of some working capital obtained from *short-term sources*. As previously suggested, working capital needs are never static. They expand as the volume of business expands and decline as the volume contracts. Often the credit extended by trade creditors is sufficient to provide the flexibility needed; at other times borrowing from banks or in the open market must be resorted to. It should be understood, however, that the need for a certain amount of long-term working capital is as definite as the fact that such capital is needed for the fixed assets; and it should be remembered that short-term capital cannot, because of its very nature, fill that need. Each of the short-term sources named in the classification given above will now be discussed in detail.

Working capital supplied by trade creditors.—Whenever goods are bought on credit, the vendor of the goods is furnishing working capital to the buyer. This is true regardless of the medium used—whether the transaction is an open book account, or whether a promissory note or an acceptance is given in payment. Credit terms vary with different businesses. On account of the great saving to be made through taking advantage of the usual cash discount allowed on cash payment for goods purchased, many concerns believe *trade credit* much too expensive a way to obtain working capital

and prefer to borrow at a bank, when necessary, in order to pay cash and save the discounts.

It is not usual to give notes at the time goods are purchased, except in the case of installment contracts and in a few other instances, and, when a note is so given, it may run for almost any period, usually bearing interest at the rate of 6 per cent.

A *trade acceptance* may be defined as "a time draft or bill of exchange drawn by the seller of goods on the buyer for the purchase price; it is accepted by the buyer and is payable on a certain date at a designated place." It does not bear interest. When accepted by the buyer it is merely, in effect, a written acknowledgment of the debt and a promise to pay at a certain date. Ordinarily, the promise is for payment in a 30, 60, or 90 day period. Usually it accompanies the invoice, though it may be mailed at the end of the month to cover all purchases made during the month. As will be shown later in this chapter, the trade acceptance is concerned much more with the working capital problems of the seller than the buyer. From the standpoint of the latter it is just another method of obtaining goods on credit and, hence, of obtaining working capital in the form of inventories from trade creditors.

Bank loans a source of working capital.—Loans for temporary working capital purposes are made by all commercial banks. It is quite proper and good business to rely on *bank loans* to supply the additional working capital needed for seasonal requirements or for increases in demand that cause a need for additional working capital. Bank loans come under the classification of special working capital. Banks must watch the liquidity of their loans, and hence will not supply the regular working capital of the business. Care must be taken in using bank loans as a source of working capital to make sure that the inventories or other current assets into which these loans are invested can be liquidated into cash in time to clear off the bank loan when it falls due. Most banks grant credit with the stipulation that the business must be out of debt to the bank for a certain period of the year. This requirement is made so that the banks may be assured of the liquidity of their loans.

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Bank loans are usually made without security; however, if the corporation owns stocks and bonds, it may offer them as collateral. Other types of collateral sometimes used are promissory notes and trade acceptances of customers. Warehouse receipts for goods stored in bonded warehouses are often used by importers for the same purpose. The obtaining of bank loans will be discussed in detail in the chapter on "Business and Banks."

The commercial paper market as a source of working capital.—*Commercial paper*, in the financial sense, means the promissory notes of short duration which large and sound business concerns frequently offer for sale through commercial paper houses on the open market. The maturity of this commercial paper is usually from one to six months, the average being about four months. The denomination of the individual notes ranges from a minimum of \$2,500 upwards; but in order to get distribution in a normal market, the most commonly used units are \$2,500, \$5,000, and \$10,000. These notes generally consist of an unsecured, single name paper of the issuer. Guarantees and endorsements sometimes occur but are unusual. Such financing is used when the need of funds is for a shorter time than that generally covered by corporate notes, as discussed in the preceding paragraphs, and when, for any reason, the issuing company prefers it to ordinary bank borrowing. Commercial paper is not used as a general substitute for bank borrowing but rather as a supplement to it, for the line of credit that a company enjoys at its bank should never be abandoned entirely. Commercial paper issues are usually for large amounts; they are seldom as small as \$50,000 or \$25,000, because the commercial paper houses cannot afford to handle small loans, since their rate of commission is only about one-fourth of one per cent.

This paper is generally sold to a commercial paper house—sometimes outright for cash, sometimes on an *advance* basis; the price received is the face value of the notes minus the market rate of discount and the commission of the commercial paper house. The commercial paper house disposes

of the notes through its various branches, agencies, and salesmen; the buyers are commercial banks who seek temporary investment of funds. Commercial paper is usually drawn to meet the eligibility requirements for rediscount with the Federal Reserve banks, and, hence, enjoys that degree of liquidity greatly desired.

The commercial paper house does not guarantee or endorse such paper—except occasionally for very large banks which refuse to accept it unless it is so endorsed—but stakes its future in the business upon the continual offering of sound material only. The losses in commercial paper are very small indeed; and in several cases where an issue has brought about a loss, the commercial paper house has itself assumed it in order to retain the confidence and goodwill of its banker-customers. Commercial paper can be bought by banks on 10-day options, during which time the banks may investigate for themselves the responsibility of the makers and return to the brokers any paper which they deem undesirable.

Before accepting paper from the issuer, the commercial paper house makes a most careful investigation of the borrower's financial and credit standing, in order to be assured of the soundness of the notes and of the certainty of their payment at maturity. It is this searching inquiry and the absolute refusal of the paper houses to accept anything that does not pass their scrutiny that makes commercial paper such a sound and safe investment.

Commercial paper offers a number of definite advantages to both the issuer and the buying banks, which account for its popularity. These advantages may be summarized as follows:

- ✓ 1. Advantages to the business man:
 - a. He may sell the paper on the open market when the local bank has no funds available for a loan.
 - b. He may sell notes at a lower rate of interest than that demanded by the local bank. As a matter of fact, the open market rate is usually lower than that prevailing in local banks.

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c. If the maker enjoys a wide reputation as a maker of *prime paper*, banks in every part of the country are willing to take it up when it is offered. This makes future borrowing comparatively easy.

2. Advantages to the bank:

a. It may thus utilize funds that are not in demand for local loans.

b. It may be able to procure better rates than it can on local loans.

c. It is under no obligation, moral or otherwise, to renew; and thus it avoids embarrassment which sometimes arises over renewal demands on local notes. It is well assured that commercial paper will be paid at maturity.

d. It can select notes having maturities fitting in exactly with the bank's needs for cash.

e. The bank's money is in obligations scattered over a wide territory, so that only a small portion may be affected adversely in case of unfavorable local conditions.

f. The bank obtains the advantage of the broker's wide investigation and careful judgment in the selection of the paper.

Methods of increasing turnover of inventories and receivables.—It has been shown that the rate of turnover of receivables and inventories has a direct bearing upon the amount of working capital a concern should have. If turnover can be speeded up, these assets are more rapidly converted into cash and the proceeds available to pay the concern's bills. Some of the methods used in accomplishing such action are:

1. Special sales.
2. Discounting of trade acceptances and customers' notes.
3. Hypothecation of accounts receivable.

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4. Granting discounts as a reward for cash payments on goods sold.

Each of these methods will be discussed briefly.

1. *Special sales.*—Retail merchants constantly use this method of keeping their stock moving. Special sales at reduced prices are advertised in the papers daily, since rapid turnover not only helps out the working capital situation, but also increases profits. Department heads and buyers pride themselves on maintaining a rapid merchandise turnover. The practice is not limited to retailers, however; many manufacturers facing large, accumulated inventories or wishing to speed up business in slack seasons reduce prices and advertise unduly. A period of declining business is especially marked by such sales, when merchants and manufacturers attempt to liquidate inventories which are becoming frozen from lack of demand.

2. *Discounting of trade acceptances and customers' promissory notes.*—This item, which is usually expressed as notes receivable on the balance sheet of a concern, may frequently be converted into cash through discounting at the bank with which the concern does business. In most lines, however, few businesses obtain enough acceptances or customers' notes to make this method an important factor. One notable exception is the automobile business, where all sales are made for cash or on installment notes. The latter are sold to a finance company, and the result is that the automobile business is practically a cash business. This practice is followed generally by most concerns selling goods on the installment plan.

3. *Hypothecation of accounts receivable.*—Some finance companies will advance funds against accounts receivable. Under the notification plan, debtors are notified that payment is to be made to the finance company. Under the non-notification plan, the payment is made to the concern hypothecating the accounts and, by agreement, turned over to the finance company. The practice generally is one used only in emergencies, because the charges made by finance companies for this type of financing are comparatively high.

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(The practice of making advances against receivables is quite common in the textile field. Concerns advancing funds against such securities are known as commercial factors. The practice is so well established in the textile business that the notification plan is commonly used. Commercial factoring seems to be widening its scope to include many other fields. Whether or not this will be a permanent situation or merely a characteristic of the present business depression remains to be seen.)

4. *Liberal cash discounts.*—It is an almost general practice in this country to find discounts of from 2 to 5 per cent allowed for cash payment within 10 days of the date of the invoice. While this reward is a large one, it probably has been allowed for in the selling price, and those who take the full credit period for payment fail to reap the advantage granted to others who pay cash. Since the taking of cash discounts offers a considerable saving, the effect is to reduce the number of credit sales and hence increase the accounts receivable turnover.

What is the proper amount of working capital?—We have seen, in our discussion of the various factors affecting working capital requirements, that the proper amount of working capital for an enterprise will vary widely not only according to the particular type of organization under consideration, but also according to the conditions under which it operates and the general status of business conditions at any one particular time. To make an arbitrary statement that the amount of working capital for any one particular industry should always be so much, or such and such a figure, at any particular time, would be quite as impossible as to answer the question: "How high is up?"

The amount necessary for a particular business can be determined only after a careful and painstaking analysis of the enterprise under consideration and a sound comparison of it with similar types of business in the same field where adequate data may be obtained as a basis for comparison. No arbitrary formula can be given by which such an amount may be estimated. The sound preparation of a well-developed budget, based on the experience obtained in the business during past years (or, in the case of a new business, a

budget which is based on the conditions of another business as near like it as possible), will go far toward providing an adequate basis for a workable estimate of the amount of working capital necessary for an enterprise. It is far better that there be too much working capital than too little, although, as will be seen, too much working capital is often-times as dangerous as too little.

✓**Advantages of sufficient net working capital.**—The proprietor of a business or the officials of a corporation, who can go home at night and sleep in peace and comfort without worrying about how wages and salaries are going to be met the next day, enjoy a position in business which can come only as a result of efficient management, which has provided adequate working capital. Consequently, while perhaps the most important advantage of sufficient net working capital—the feeling of security and confidence which should come to every well-managed and successful business—is more or less intangible, there are, nevertheless, a number of really tangible advantages open to the business with sufficient ready working capital and strong lines of credit which may be drawn upon when needed. These may be briefly enumerated as follows:

1. A real sense of security, resulting from a sufficient amount of working capital on hand, will create confidence and loyalty not only throughout the business itself, but also among its customers, creditors, and business associates.

2. Advantage may be taken of cash discounts in the purchase of raw materials or merchandise, resulting in a saving in interest charges on the amount of working capital employed.

3. A strong credit position can be maintained, enabling the company to rest securely in the confidence of its bankers, who, in turn, will be more willing to lend the cash for seasonal working capital needs at favorable rates and on liberal terms without guaranty or indorsement.

4. The necessity of raising cash in periods of emergency makes it advantageous for a company always to carry a reasonable amount of surplus cash.

5. Advantage may be taken in purchasing raw materials,

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coal, or other factory supplies in a sharply advancing market, or in off-season periods, resulting in substantial savings where storage costs are not prohibitive.

Some general rules for the administration of working capital.—While the whole problem of the administration of cash and working capital is intimately and closely tied up with the almost limitless problems of cost accounting, organization, and management, there seem to be certain guides which may be laid down. These general points, if they may be so called, may be summarized as follows:

1. Fixed administration expenses should be reduced to a minimum in order that the business may be as nearly elastic as are the business conditions affecting it and the country in general.

2. All processes of the business should be analyzed and logically synthesized and applied to future plans and budgets.

3. The units in the several departments should be of such size that each department will be used to its full capacity. Thus, no unnecessary waste will occur.

4. Unnecessary, unproductive, fixed operating assets should be salvaged and turned into cash.

5. The business should provide a dividend policy that will readily attract new capital.

6. The management must keep the credit of the company at the bank good for seasonal and emergency demands for cash.

7. The concern should use supplementary financial agencies (commercial paper broker, trade acceptance, banker's acceptance, etc.) for raising cash when expedient.

8. The management must provide enough initial working capital for every step in expansion to permit regular capital to perform its ordinary functions without undue strain.

9. The management must, also, provide ample regular working capital, through the sale of stock and bonds, or through the plowing in of surplus earnings.

10. It is necessary to keep a cash budget, in order to forecast the demands for cash funds and the sources from which cash may be derived.

FINANCIAL BUDGET		PERIOD													
		FROM	TO	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
ESTIMATED SALES.....															
RECEIPTS:															
Cash Sales.....															
Accounts Receivable.....															
Notes Receivable.....															
Other Income.....															
Security Sales.....															
TOTAL RECEIPTS.....															
DEBITMENTS:															
Direct Labor Payroll.....															
Indirect Labor Payroll.....															
Purchases.....															
Administrative Salaries.....															
Insurance.....															
Taxes.....															
Miscellaneous Expenses.....															
Dividends:															
Preferred.....															
Common.....															
Interest:															
Bonds.....															
Bank Loans.....															
TOTAL DEBITMENTS.....															
EXCESS OR DEFICIENCY*															
CASH BALANCE BEGINNING.....															
BORROW DURING MONTH.....															
REPAY DURING MONTH.....															
CASH BALANCE ENDING.....															

Cash or Financial Budget of a Manufacturing Company.

* In red.

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The cash or financial budget.—One of the best means not only of conserving working capital but also of anticipating actual cash requirements of a business is to prepare a cash budget. In principle, this budget is made up of two parts: (1) an estimate of the expected monthly cash receipts for a future period; and (2) an estimate of disbursements for the same period. One is matched against the other, the balances cumulated, and the result is the monthly cash position. One form of such a statement is reproduced on page 265.

The preparation of a cash or financial budget is one of the final steps in budgetary procedure. Before an estimate of cash balances or requirements can be arrived at in this manner, considerable work must be done. Monthly sales must be estimated, expected collections computed, and receipts from all other sources estimated. Budgets, based on the sales estimate, are prepared to cover the expenses of the producing department. Each and every department estimates its expenditures, and all of these are summarized in their proper places in the cash budget.

A few of the many advantages of such procedures are stated below:

1. A standard of performance has been established for every department of the business.
2. Since all plans are drawn at the same time and consolidated in one budget, needless wastes through duplication can be noted and eliminated.
3. Business plans can be modified to meet financial possibilities before it is too late to make requisite changes.
4. Budgeting, if not demanded by the bank, is an important element in favor of a business when it is seeking a bank loan.
5. A budget acts as a check on imprudent expansion.
6. Expenses are best controlled through a budget.
7. It is the only way that cash requirements can be determined in advance.

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Questions for Study and Review

1. Define: (a) working capital; (b) net working capital.
2. What is meant by: (a) cash position; (b) quick ratio; (c) current ratio?
3. Name seven factors affecting working capital requirements.
4. State the formulas for determining: (a) raw material turnover; (b) work in process turnover; (c) finished goods turnover.
5. Name several sources of working capital which come under the following classifications: (a) long-term sources; (b) short-term sources.
6. Discuss the use of bank loans as a source of working capital.
7. Explain in detail what is meant by commercial paper.
8. State the advantages of commercial paper to the firms which issue it and to the bankers who buy it.
9. Name and briefly discuss four methods of increasing turnover of inventories and receivables.
10. Name five advantages of providing for sufficient working capital.
11. State ten general rules for the administration of working capital.

Problems

1. Examine the balance sheet of the John Doe Manufacturing Company on page 247, and derive:
 - (a) Gross working capital.
 - (b) Net working capital.
 - (c) Current ratio.

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(d) Cash position (notes payable in the balance sheet indicate bank loan).

(e) Quick ratio.

2. The Storm Manufacturing Company plans to market a new machine which is to sell for \$110; the following estimates of cost per machine were made:

a. Total cost of production ⁴	\$80
b. Selling and administrative expense	10
Total cost	\$90
Expected profit	20
Sales price	\$110

The terms of sale are 4% 10 days net 30 E. O. M., and one-half the customers are expected to take advantage of the discount offered.

The estimated volume of business and production is as follows:

100 machines per month during the first month.

200 machines per month during the second month.

300 machines per month during the third month.

400 machines per month during the fourth month.

500 machines per month during the fifth month and thereafter when capacity production is reached.

Show by the construction of a simple cash budget the additional demands for working capital which will be incurred before the business is "On its feet."

3. Compare the needs for working capital of an electric light and power public utility with those of a steel manufacturing company.

4. The annual sales of the Bates Department Store are \$900,000, cost of sales \$600,000, selling and administrative expenses \$200,000. An average inventory amounting to \$200,000 is maintained.

(a) What is the present rate of turnover of inventory?

(b) If the sales are increased to \$1,350,000, cost of sales to \$900,000, average inventory remaining the same, what would be the new rate of turnover?

(c) If sales remain at \$900,000, and cost of sales at \$600,-

⁴For the sake of simplicity no allowance is made for the fact that unit overhead cost would probably decrease as volume increased.

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000., but inventory can be reduced by more careful control to \$150,000., what would be the new rate of turnover?

(d) If capital to carry inventory costs 6 per cent, would the sales increase (b) or the inventory reduction (c) be likely to prove most profitable, assuming that of the selling and administrative expenses 40 per cent, or \$80,000., are fixed, and 60 per cent vary with the volume of sales? Assume also that the cost of insurance is 0.2 per cent and storage expense one per cent of the value of the inventory.

CHAPTER XV

Surplus, Dividend, and Reserve Policies

Income.—From the point of view of the business man, *income* is always defined in terms of money. He considers as income the money receipts or claims to money derived from his business. Income is derived ordinarily from three sources: (1) revenue from regular operations; (2) revenue from outside operations; and (3) revenue from investments. Since it is from these three sources that surplus and dividends chiefly originate, a brief discussion of each may be helpful.

Income from operations.—In the income statement of Goodyear Tire and Rubber Company, which is reproduced below on page 273, the *gross income from operations* arises from the sales of their product. If the income statement were that of a railroad, the gross income from operations would consist of the revenue from passenger traffic, freight, express, mails, and other sources, less the expenditures necessary to obtain it.

Income from outside operations.—Income may arise from operations not directly connected with the main business of the company. For instance, a railroad company, in order to attract tourists and thereby increase its revenues from passenger traffic, may operate hotels. The income from these hotels would be considered as *income from outside operations*. The Canadian Pacific Railway operates such a hotel system. A local factory sells electric power to the village in which it is located. The income so received is outside revenue.

Income from investments.—*Income from investments* is often termed *other income*; it consists of dividends on stocks owned or interest on bonds owned. Sometimes this item is considerable. In the case of a pure holding company, the

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only source of income is that obtained from the securities of other corporations owned. Hence, this item would take the place of operating revenue which appears in the income statement of an operating company. The usual practice, however, is to combine the income statements of all the subsidiary corporations into one consolidated statement and to show the results as though the combinations were one big operating company. The income statement reproduced in this chapter (see page 273) is an illustration of such a statement.

Adequacy of income.—The income of any business must of necessity be sufficient to pay all operating expenses, including the upkeep of the property, and still have enough money left over to pay interest on borrowed capital and a fair return on the owners' investment. If this cannot be done, the business must soon cease to operate. Money is invested in a business solely to produce profits; it is this feature which distinguishes business from philanthropic activities.

No standard can be established as to adequacy of revenue. That point is determined by the nature of the business. As it has been shown in the chapter on financial planning, investors are more inclined to be content with a small return where the safety of the business is reasonably assured than they are with a big profit when there are many hazards.

Relation of income to fixed charges.—The directors must take care that their company does not issue bonds calling for interest payments which are likely to exceed the available gross income. As observed above, where the operating revenues are stable and the operating expenses are fairly constant, the business may incur a larger percentage of fixed charges. If the margin above the interest is too narrow or the operating ratio too high, relief must be sought by: (1) reducing fixed charges; (2) reducing the operating expenses without a corresponding reduction in the operating revenues; or (3) increasing the operating revenues more rapidly than the operating expenses.

The reduction of the funded debt is usually a difficult task requiring the consent of the bondholders, or, if the bonds are redeemable, requiring cash or occasionally a refunding issue

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either of stocks or bonds. The difficulties involved in the adjustments of such debts of a company are treated in Chapter XI.

THE GOODYEAR TIRE & RUBBER COMPANY AND SUBSIDIARY COMPANIES

CONSOLIDATED PROFIT AND LOSS AND EARNED SURPLUS ACCOUNT FOR THE YEAR ENDING DECEMBER 31, 1937

NET SALES (returns, discounts, freights, allowances, excise taxes and inter-company sales deducted)	\$216,174,513.39	
Deduct—Manufacturing cost and charges (depreciation provided \$8,010,178), selling, administrative and general expense and provision for Federal income and other taxes . . .		196,209,531.70
		<u>\$ 19,964,981.69</u>
Add—Other income.....		1,114,468.05
		<u>\$ 21,079,449.74</u>
TOTAL PROFITS BEFORE INTEREST, OTHER CHARGES AND ADJUSTMENTS.....		
Deduct—Interest and other charges:		
Interest on funded and miscellaneous debt.....	\$2,681,385.23	
Proportion of discount on funded debt, less adjustments of securities purchased for redemption ..	84,011.52	
Dividends and equity in undistributed earnings of subsidiaries not wholly owned by The Goodyear Tire & Rubber Company.....	714,023.16	3,479,419.91
		<u>\$ 17,600,029.83</u>
NET PROFITS—before adjustments.....		
Deduct—Adjustments of values of rubber and cotton in raw material and finished product inventories and commitments from cost to market.....		10,342,742.65
		<u>\$ 7,257,287.18</u>
NET PROFITS CARRIED TO EARNED SURPLUS.....		
EARNED SURPLUS, DECEMBER 31, 1936.....		23,353,313.85
		<u>\$ 30,610,601.03</u>
Deduct:		
Dividends of The Goodyear Tire & Rubber Company:		
On \$5.00 convertible preferred stock for year 1937.....	\$3,393,463.75	
On \$5.00 convertible preferred stock for balance of year 1936.....	436,653.50	
On common stock.....	5,040,975.00	
Premium and accrued dividends on preferred stocks redeemed.....	317,647.00	9,188,739.25
		<u>\$ 21,421,861.78</u>
EARNED SURPLUS AT DECEMBER 31, 1937, Per Balance Sheet.....		

STATEMENT OF CAPITAL SURPLUS FOR THE YEAR ENDING DECEMBER 31, 1937

CAPITAL SURPLUS AT DECEMBER 31, 1936.....	\$ 19,138,528.93	
Deduct:		
Adjustment of 671,013 shares of \$5.00 convertible preferred stock to \$100.00 per share.....	\$ 223,671.00	
Other capital adjustments.....	81,719.20	305,390.20
		<u>\$ 18,833,138.73</u>
CAPITAL SURPLUS AT DECEMBER 31, 1937, Per Balance Sheet.....		

The second expedient, that of reducing the operating expenses without a proportionate decline in operating revenues, is equally hard to achieve. It will be remembered that attention was called to the fact that a large percentage of operating expenses is fixed; also, that a reduction would

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be likely to disrupt the organization, which would result temporarily in inefficiency and loss. Industries which have as their chief item of expense the wages to unskilled labor and which have little fixed capital can most readily adjust their operating expenses to correspond with their operating revenues.

Perhaps the third method is the most feasible. Greater concentration on advertising and selling, with special attention given to customers and the careful and expeditious filling of orders, may produce the desired effect. Attention is called to the advantage of large-scale production which, when it is possible to apply it, results in lower unit operating costs.

✓ **Desirability of stable income.**—There are many reasons why steady revenues are desirable. Chief among them are the following:

1. A larger percentage of the capitalization can be composed of bonds with fixed charges, but with lower interest rates. This feature makes possible larger returns to the owners; that is, the stockholders.

2. More definite production and financial plans may be devised, because of the relative certainty of the requirements.

3. A permanent organization can be maintained, a factor which will result in economies to the business.

4. The credit standing of the company is improved. This point applies particularly to the sale of securities, which makes possible cheaper financing.

5. Stability of dividends follows, giving investment characteristics to the stock.

Outgo necessary to obtain income.—Some expenses are incurred in every business. A railroad, for instance, must pay for coal, for wages, and for a multitude of other items, in order to perform the service from which it obtains its income. In addition to the cash outgo for all of these various expenses, the physical equipment of the railroad is constantly deteriorating through wear and tear and the action of the elements. Parts of the equipment decline in value, too, through becoming antiquated, even though they may

still be fit for the purpose for which they were originally designed. Obviously, no immediate cash outgo results from this gradual decline in the value of the railroad's assets; yet, it must be considered as an expense of doing business. This loss in value is known as *depreciation*; because of its importance from the standpoint of financial policy, the subject demands special attention.

Depreciation.—*Depreciation* is the loss in value of tangible assets arising from physical, functional, and accidental causes; also, it includes the loss in value of intangible assets that are affected by time limitation or abandonment. The term *depreciation* applies to assets whose duration might be prolonged by repairs, renewals, or replacements; and to intangible assets which are limited in respect to time, such as patents, copyrights, limited franchises, leases, and so forth.

It does not, however, apply to current assets other than merchandise or stock in trade. Depreciation is a charge relating to the past. It is customary to offset losses in value resulting from depreciation by reserving part of the annual earnings. The usual method is to include the depreciation charge in the operating expenses, because it is considered an operating expense.

Deterioration.—*Deterioration* is used to designate a loss in substance. This loss arises through wear and tear in the normal use of the asset, or it may be due to decay through the action of nature. Deterioration renders the asset less valuable¹; hence, it depreciates.

Depletion.—Depletion arises in connection with assets which cannot be replaced, or the duration of which cannot be lengthened by repairs and renewals. These assets are sometimes referred to as *wasting assets* as they are constantly being converted from fixed property investments to stock-in-trade and are sold as product. Oil wells and mines are subject to *depletion*; buildings and machinery *depreciate*.

Causes of depreciation.—Depreciation may be the result

¹ *Valuable* is used in the sense of exchange value, for the asset may still be just as desirable to the owner, since it may still serve his purposes quite as satisfactorily as when acquired. We cannot entirely measure the efficiency of a plant by the extent of its depreciation. A plant, to be efficient, usually needs to be maintained only up to from 75 to 90 per cent of its original cost.

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of many causes, operating sometimes jointly and at other times singly. It must always be remembered that the effect is not cumulative, and that the cause which will result in complete depreciation in the shortest time will dominate. The whole process is known as *effective depreciation*, and serves as a basis for the depreciation charges. The cause may never, for instance, be both inadequacy and obsolescence at the same time; one predominates.

The various causes of depreciation are²:

I. TANGIBLE PROPERTY:

- | | | | |
|-----------------------|---|---------------------------------|---------------------------|
| A. <i>Physical.</i> | { | 1. Wear and tear. | |
| | | 2. Decrepitude—age. | |
| | | a. Action of time and elements. | |
| | | | |
| B. <i>Functional.</i> | { | 1. Inadequacy. | |
| | | 2. Governmental requirements. | |
| | | 3. Obsolescence. | |
| | | | |
| C. <i>Contingent.</i> | { | 1. Accidents. | { |
| | | | a. Negligence. |
| | | | b. Elements. |
| | | | c. Structural defects. |
| | | 2. Diseases. | { |
| | | | a. Parasites. |
| | | | b. Pollution of water. |
| | | | c. Growths in water mains |
| | | | d. Electrolysis. |
| | | | e. Crystallization. |
| | | 3. Diminution in supply. | { |
| | | | a. Oil. |
| | | | b. Natural gas. |
| | | | c. Water. |
| | | | d. Metals. |

II. INTANGIBLE PROPERTY RIGHTS:

- A. *Limited in time.*
- B. *Abandoned.*

From the above chart it will be observed that there are two general classes of property; namely, *tangible* and *intangible*, which are subject to depreciation. The depreciation of tangible property is classified under three general

² Modified form of chart in Kester, Roy B., *Accounting Theory and Practice*, Vol. II, p. 121.

causes: *physical*, *functional*, and *contingent*. Intangible property, consisting of rights, is affected by the *lapse of time* and by *abandonment* before time has rendered it worthless.

Depreciation policy.—The depreciation policy of a business is evidenced by the rate at which depreciation is charged off each year. It must be remembered that depreciation is a cost of doing business which must, along with other expenses, be considered in determining net profits. A concern which is liberal in the amount charged off each year is said to have a *conservative depreciation policy*. In considering a depreciation policy, a concern must include a maintenance policy. A concern which is on the alert to repair and renew its equipment to the point of efficiency prolongs the life of its assets and thereby reduces the amount necessary to charge to depreciation each year. Maintenance, therefore, is directly connected with depreciation, and both together constitute a concern's expenses for depreciating assets. At this point, however, it must be recalled that while maintenance involves a cash outlay, depreciation is a bookkeeping charge against the profits.

Calculating the amount of the depreciation charge.—There are many methods of calculating the amount to be charged off each year as the loss in value due to the depreciation of assets. The soundest of these are based on three elements; namely, (1) the original or cost value of the asset, (2) the length of time it may be profitably used in the business, and (3) its junk value at the end of this period. It should be realized that depreciation has no direct relationship to gross earnings, for it may be due to the action of time and the elements or to obsolescence and other factors which exist regardless of the rate of plant operation. While it may seem expedient for a concern to vary the amount of depreciation with the amount of earnings, there is no sound basis for doing so. The three factors named above deserve primary consideration.

Depreciation is often expressed as a percentage of the value of the assets. An asset which lasts a long time will, of course, have a smaller percentage of its value charged off each year. The depreciation charged off by the Chrysler

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Corporation is based upon the following annual rates^a:

BUILDING GROUP:		MACHINERY GROUP:	
Building	2½%	Machinery and equip- ment	10%
Grounds	7%	Power transmission	10%
Water and sewerage	5%	Furnaces, forges, ovens, etc.	15%
Heating and ventilating .	5%	Miscellaneous	15%
Electrical installation ...	7½%	Factory cars	33½%
Gas installation	7½%	Tools and dies (amor- tized over car produc- tion)	
Air installation	7½%		
Sprinkler installation ..	5%		
Furniture and fixtures ..	10%		

The above figures express the individual rates employed by this company. For purposes of rough analysis of the depreciation policy of any company, a composite rate can usually be obtained which will indicate the percentage of the book value of the plant equipment charged off each year. This rate can be arrived at easily through an inspection of the company's financial statement for consecutive years.

What is surplus?—The *surplus* of a corporation may be defined as the excess of its assets over its liabilities and capital stock; it is shown by the balance sheet of the corporation. Assets may be tangible or intangible.

The consolidated balance sheet of the Goodyear Tire and Rubber Company, which is reproduced on pages 282-283, shows an earned surplus of \$21,421,861.78. This amount includes the current profits as well as the surplus accumulated from previous years, and capital surplus.

The amount of profit for the current year is indicated by the item "Net Profits carried to Earned Surplus," which appears in the income statement (page 273). The current year's earnings are sometimes referred to as the *profit and loss surplus* for the year.

↓ **Sources of surplus and availability for dividends.**—Surplus is not necessarily the result of accumulated profits; that is, profits held in the business. Since surplus merely represents the excess of assets over liabilities, any revaluation

^a "Individual Reports Section," *Standard Corporation Records*, Vol. 16, Sec. 7, No. 3522, March 22, 1938, published by the Standard Statistics Co., New York.

of the assets not resulting in an equivalent increase in liabilities, or any reduction in liabilities which does not also involve a reduction in the amount of the assets, results in increased surplus. However, in perhaps the great majority of businesses the surplus shown on the balance sheet represents undistributed earnings.

In the accumulation of surplus, profits constitute the most satisfactory and general source; but surplus arises from many other sources. These sources should be well known and understood by the financial administrator in order that he may accurately determine the real worth of the surplus. The sources of all surplus should be taken into careful consideration when the declaration of dividends is contemplated.

While directors have the legal right to declare a dividend from any surplus which may exist, it may not always be expedient or good financial policy to do so. All surplus should be administered for the best interests of the company, and wide discretion may be used in handling it. But, ordinarily, surplus should be used only for the purpose for which it was acquired. Probably the best test that directors can apply as to its distribution is to determine the source from which that part of the surplus under consideration has come, and from this, to decide whether it is properly available for dividends.

The principal sources of surplus are:

1. *Current earnings from operation.*—This is the primary source to which the business should look for the building up of its surplus. Surplus derived from this source may be properly used for dividends.

2. *Other income.*—Under this head come rentals and interest and dividends on bonds and stocks held. Some companies lease out all their property, and the rentals therefrom constitute the entire income; others often lease portions of their property and derive income in the form of rentals. Parent companies, operating with a number of subsidiaries, often receive a large part of their income in the form of dividends on the stock of the subsidiaries; and non-operating holding companies obtain practically their entire

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income from this source. Many large companies have considerable amounts invested in bonds; the interest from these constitutes their income. Surplus derived from *other income* is properly available for dividend purposes.

3. *Sale of stocks and bonds at a premium.*—Whether securities are sold at par, at a discount, or at a premium, they are charged as a liability of the issuing company at par value. This practice gives rise to a *capital surplus*, which should be so labeled in order to indicate its source. The Interstate Commerce Commission requires railroads to designate this item as “Premium on Securities Sold” in order that there may be no doubt as to its source.

A surplus which has been created through the sale of stocks or bonds at a premium should not ordinarily be used for dividends. This is often known as *capital surplus* and is kept as a separate fund. The securities were sold to raise capital, and the entire proceeds of the sale should really belong to the capital. Sometimes securities are sold at a premium for the specific purpose of using for dividends the surplus created by the premium. This is justifiable, provided the purchasers understand the circumstances and know that the dividends when paid are not represented as coming out of earnings.

4. *Sale of assets for more than book value.*—Companies which carry their assets at a conservative valuation sometimes have an opportunity to dispose of parts of them, especially unused real estate, at an advantageous price. Such a procedure, of course, increases the surplus by the amount by which the sale price exceeds the book value.

A surplus created by selling assets above their book value makes, in reality, a capital surplus, and should ordinarily be kept in the company. If there is apparently no possibility of ever having to replace the asset, the excess may in such cases be disbursed to stockholders.

5. *Upward revaluation of assets.*—When it is found that any asset is actually worth more than the valuation at which it is carried on the books, it may, in some instances, be revalued at its worth. Such revaluation, of course, increases the amount of the total assets without creating any offsetting liability, and so helps to build up the surplus. Un-

scrupulous operators may write up the value of the assets beyond their worth. This practice creates a surplus on paper which is, of course, false; and the practice is entirely unjustifiable.

A surplus created by the upward revaluation of assets is not usually dispensed as dividends. The assets revalued later may prove to have been unjustifiably written up, or, if they were justly written up, they may again fall off in value.

6. *Donated surplus.*—Any donation of value made to a business may be added to its surplus. The most common form of donation is that of stock donated to the treasury by one who has received stock in return for property, patents, services, etc. The real value of such treasury stock as an asset, however, is in most cases very questionable.

Surpluses caused by donations to a business should, of course, be used for the purpose stipulated by the donor. Where stock is donated to the treasury, it is seldom good policy to use the surplus thus created for dividends. In the first place, this surplus is capital surplus rather than earned surplus; and in the second place, the questionableness of the value of the treasury stock makes the surplus created thereby of dubious value.

7. *Surplus inherited from constituents of consolidation.*—Surplus turned in by one or more of the businesses forming a consolidation goes toward building up the surplus of the consolidated company.

A surplus appearing in the balance sheet of a consolidated company, as a result of its taking over the surpluses of constituent companies, should be used by directors in whatever manner will best serve the interests of the consolidated company. It is quite common, however, for directors to be guided in the use of such surplus by a careful consideration of the purposes and sources of the surpluses in the companies from which they were respectively derived.

8. *Conversion of unnecessary reserves.*—Reserves, as will be shown later in this chapter, are, in reality, portions of the earnings which are set aside from the surplus for what are deemed necessary purposes before either the dividends or the surplus is determined. If one of these reserves is

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		THE GOODYEAR TIRE AND SUBSIDIARY	
		CONSOLIDATED BALANCE	
		ASSETS	
PROPERTY ACCOUNTS:			
Land, buildings, machinery and equipment at cost.....		\$174,090,895.03	
Less: Depreciation.....		95,486,573.65	\$ 78,604,321.38
INVESTMENTS:			
Bond purchase fund.....		\$ 300,000.00	
Land sales contracts and mortgages, less reserves.....		961,308.48	
Pension trust fund.....		3,827,064.07	
Miscellaneous, less reserves.....		905,155.65	5,992,528.20
CURRENT ASSETS:			
Inventories at cost or market whichever is lower.....		\$ 73,987,017.04	
Accounts and notes receivable:			
Trade.....	\$26,433,936.65		
Other.....	1,229,340.29	\$27,663,276.94	
Less: Reserves for bad debts, discounts and allowances.....		4,627,267.28	23,036,009.66
Canadian Government securities at cost or market whichever is lower.....		537,817.00	
Cash on hand, demand and time deposits..		11,074,247.68	108,635,091.38
GOODWILL, PATENTS AND TRADE- MARKS.....			1.00
DEFERRED CHARGES TO FUTURE OPERATIONS:			
Discount on funded debt, less amount writ- ten off.....		\$ 1,053,235.57	
Prepaid insurance and other expenses.....		646,761.54	1,699,997.11
			\$194,932,939.07

found to be unnecessary, it is perfectly proper to abolish it and to put the amount that had accumulated in the reserve back into the surplus.

Surplus from the conversion of unnecessary reserves is properly available for dividends, if it is not more urgently needed for some other purpose in the business. This reserve was originally held back out of earnings the entire sum of which would otherwise have been available for dividends;

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& RUBBER COMPANY COMPANIES

SHEET, DECEMBER 31, 1937

LIABILITIES

CAPITAL STOCK OF THE GOODYEAR TIRE & RUBBER COMPANY:

\$5.00 Convertible preferred stock, cumulative, no par value:			
Authorized November 21, 1936	800,000 shares		
Less: Converted and cancelled	90,596 shares		
Present authorized	709,404 shares		
Outstanding	657,333 shares		
Less: Held in treasury	6,865 shares		
	650,468 shares	\$65,046,800.00	
Second preferred stock, \$7.00 cumulative, no par value:			
Authorized	189,025 shares		
Outstanding	None		
Common stock:			
Authorized—5,000,000 shares—no par value:			
Outstanding	2,061,349 ^{1/8} / ₁₀₀ shares		
Less: Held in treasury	2,288 ^{1/8} / ₁₀₀ shares		
	2,059,060 ^{1/8} / ₁₀₀ shares	10,993,923.50	\$ 76,040,723.50

CAPITAL STOCK OF SUBSIDIARY COMPANIES NOT HELD BY THE GOODYEAR TIRE & RUBBER COMPANY (at book values):

Preferred stocks	\$ 8,736,150.00		
Common stock	1,768,597.16	10,504,747.16	

FUNDED DEBT OF THE GOODYEAR TIRE & RUBBER COMPANY:

First mortgage and collateral trust 5% bonds, due May 1, 1957	\$60,000,000.00		
Less: Redeemed	7,634,500.00	52,365,500.00	

SUBSIDIARY COMPANIES REAL ESTATE MORTGAGES CURRENT LIABILITIES:

Accounts payable, including reserve for Federal income taxes	\$ 8,700,816.91		
Accrued interest	436,379.16	9,137,196.07	

RESERVES:

Pension trust fund	\$ 3,827,064.07		
Commitments	1,208,531.84		
Miscellaneous	1,411,413.85	6,445,009.76	

CAPITAL SURPLUS, as per statement attached	18,833,138.73		
EARNED SURPLUS, as per statement attached	21,421,861.78		

\$194,932,939.07

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF THE GOODYEAR TIRE & RUBBER COMPANY:

We have made an examination of the consolidated balance sheet of The Goodyear Tire & Rubber Company and its subsidiary companies as at December 31, 1937, and of the consolidated statements of profit and loss and surplus for the year 1937. In connection therewith, with respect to the parent company and its domestic and principal foreign subsidiary companies, we examined or tested accounting records and other supporting evidence and obtained information and explanations from officials and employees of the companies; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions. The accounts of certain foreign subsidiary companies have been examined by other responsible accountants and confirmed to us.

In our opinion, based upon such examination, the accompanying consolidated balance sheet and related statements of profit and loss and surplus, fairly present, in accordance with accepted principles of accounting consistently maintained during the year under review, the position of the combined companies as at December 31, 1937 and the results of their operations for the year.

PRICE. WATERHOUSE & CO.

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and, if no longer needed, it should properly be made available to the stockholders.

9. *Accumulations of surplus from former years.*—Any surplus built up during former years is, of course, added to the current surplus to make the total or accumulated surplus.

Surplus accumulated as undistributed profits from former years is properly available for dividend purposes at the discretion of the directors. It is frequently drawn upon to enable a company to make an average dividend payment when the current earnings are insufficient. If this accumulated surplus becomes larger than is necessary, it is generally the custom to reduce it by the declaration of extra dividends.

10. *Surplus from reduction in value of capital stock.*—By various recapitalization processes, surplus is sometimes created through reduction in the stated value of a corporation's stock, such as the reduction in par value or reduction in the number of shares with the consent of the stockholders, and reduction in the stated value of the company's non-par stock.

Surplus derived through such recapitalization processes should not be used for dividend purposes. Such practice may result in rendering directors liable for impairment of the capital of the corporation.

11. *Surplus from purchase of capital liabilities.*—Surplus in the nature of a capital surplus is also derived from the purchase of the corporation's own bonds and stocks below par or the value of which the stock is carried on the liability side of the balance sheet. Funds derived from the original sales of such securities are part of the capital of the corporation and dividends should not be paid from a surplus arising in this manner.

Reserves.—Reserves on a balance sheet indicate segregation of surplus for various purposes. Not all of the surplus may be available for dividends. For instance, if no deduction for depreciation has been made from the book value of the assets, the amount should be shown as a *reserve for depreciation*; otherwise, stockholders may think that the entire amount, as shown, is available for dividends, and they may clamor for its distribution as such. The directors and the officers of a corporation may feel that the earnings, or a large

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portion of them, should be retained for working capital or for the expansion of the business. This idea may give rise to the creation of a *reserve for working capital* or a *reserve for expansion*. The effect of the reserves on the surplus may be readily seen by comparing the two simple balance sheets which follow:

I	
ASSETS:	LIABILITIES:
Cash.....\$ 40,000.	Accounts Payable....\$ 30,000.
Accounts Receivable.....\$ 35,000.	Notes Payable..... 40,000.
Less Reserve for Bad Debts..... 3,000.	Capital Stock..... 200,000.
	Surplus..... 47,000.
Inventories..... 35,000.	
Land..... 80,000	
Buildings..... 100,000.	
Machinery..... 30,000.	
Furniture and Fixtures..... 10,000.	
Less Reserve for Depreciation . 10,000.	
<u>130,000.</u>	
<u>\$317,000.</u>	<u>\$317,000.</u>

II	
ASSETS:	LIABILITIES:
Cash.....\$ 40,000.	Accounts Payable....\$ 30,000.
Accounts Receivable..... 35,000.	Notes Payable..... 40,000.
Less Reserve for Bad Debts... 3,000.	Capital Stock..... 200,000.
	Reserve for Working Capital..... 10,000.
Inventories..... 35,000.	Reserve for Expan- sion and Promotion 6,000.
Land..... 80,000.	Reserve for Dividend Equalization..... 6,000.
Buildings..... 100,000.	Reserve for Taxes... 10,000.
Machinery..... 30,000.	Surplus..... 15,000.
Furniture and Fixtures..... 10,000.	
Less Reserve for Depreciation . 10,000.	
<u>130,000.</u>	
<u>\$317,000.</u>	<u>\$317,000.</u>

Other reserves may be established for various purposes. Purposes of reserves.—Reserves are set up in various businesses for almost innumerable purposes, but the most important of these are:

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1. *Reserve for depreciation.*—This general term may indicate the sum of a number of specific depreciation reserves. Most assets depreciate; hence, we have reserves for the depreciation of buildings, machinery, patents, copyrights, fixtures, furniture, inventory, and other assets. While depreciation is reckoned as a cost of production rather than a method of showing the true value of assets, nevertheless, this end is accomplished and the present net value of an asset is generally obtained by deducting the depreciation reserve from the amount at which the asset is carried on the books.

2. *Reserve for working capital.*—This reserve indicates that it is deemed wise to use a part of the surplus for working capital purposes. Its presence in a balance sheet usually indicates intelligent financial management.

3. *Reserve for bad debts.*—Some of a firm's accounts receivable are uncollectible. This portion varies in size in different businesses. It is not difficult, however, to determine the percentage of bad debts in any particular company. It is customary to offset the asset, "Accounts receivable," with a reserve to take care of bad debt losses.

✓ 4. *Reserve for equalization of dividends.*—Stability of dividends is, as will be shown later, greatly to be desired by any business. It is, therefore, a very wise policy to reserve from the income of prosperous years certain sums which may be accumulated and used to keep the dividends up to normal in lean or poor years, when the current earnings are too small to do so.

5. *Reserve for expansion and promotion.*—A part of the earnings may be retained in the business for these purposes year by year, or as occasion may require. When the earnings are of sufficient size to justify this method of financing expansions and promotions, the retention of part of the surplus for the purpose is usually better than distributing the profits as dividends and then selling additional securities to raise funds.

6. *Reserve for stated obligations.*—When a sinking fund is provided for in connection with a bond issue, or established for the redemption of stock or for the protection of certain stock as to dividends or principal, or for any purpose whatever, it becomes a stated obligation; and the fund on

the asset side should be offset by a corresponding reserve on the liability side. Directors should take care to see that all such reserves are provided for before dividends are declared.

7. *Reserve for taxes.*—Taxes do not, as a rule, conveniently fall due just before the balance sheet is made up. In fact, while the customary annual balance sheet is made up as of the end of the calendar year, the heavy income taxes become due on the following March 15, and other taxes at various times. Good financial managers, therefore, assure themselves of being able to meet the taxes by setting aside an adequate tax reserve.

8. *Reserve for insurance.*—Many companies carry their own insurance; that is, they set aside a reserve each year which will accumulate and which may be used to replace property lost through fire, accident, etc. If a business has a number of insurable units which are widely scattered, and will be able to go through the first several years without serious loss, it can frequently cut down on expenses by using this method instead of paying regular premiums to insurance companies. In doing so, however, it takes considerable risk, which is entirely absent if it insures with an outside company. Railroads may carry this risk in comparative safety on many of their assets.

9. *Reserve for pensions, welfare, etc.*—It is a common practice among businesses to engage in various welfare activities among their employees as well as to operate a pension system for superannuated workers. Funds for these purposes are partially or wholly provided through making appropriate reserves from the earnings of the businesses.

| **Directors' responsibility for surplus policy and dividends.**—In a general sense the directors have the sole power of declaring dividends in a corporation. They must not pay dividends out of the capital. That is, there must actually be a surplus available if dividends are declared. The surplus need not necessarily be an earned surplus to satisfy the legal requirements. It is possible to *create* a surplus by *writing up* the value of the tangible assets or by including an intangible item of goodwill on the asset side of the balance

sheet. If these values exist, there is, in the absence of a statute, nothing illegal in the practice, though it is usually not considered good financial practice to create a surplus in this manner. A surplus may also be created by reducing the stated value of no-par stock or by reducing the par-value of par value stock. The same object could be accomplished by reducing the amount of stock outstanding. These latter practices are often difficult to accomplish because they require in most states the consent of all, or a two-thirds majority, of the stockholders.

Directors have been forced to repay dividends when they have been paid out of capital. They have been forced, also, to pay dividends when the stockholders have been able to show in court that they were being treated inequitably through the failure of the directors to declare certain dividends. The Dodge Brothers forced the Ford Automobile Company to distribute dividends to them as stockholders (See *Dodge v. Ford Motor Co.*, 204 Mich. 459; 170 N. W. 668; 3 Am. L. Rep. 413-449).

✓ **Forms of dividend payments.**—Dividend payments are usually made quarterly, though occasionally small corporations make payments semi-annually or annually. Dividends may be paid in:

- | | |
|-----------|--------------|
| 1. Cash. | 4. Bonds. |
| 2. Stock. | 5. Property. |
| 3. Scrip. | |

1. *Cash dividends.*—Cash is the usual form of dividend. A cash dividend is practically always desired by stockholders in preference to dividends of any other type.

2. *Stock dividends.*—Dividends are often paid in stock instead of in cash. A stock dividend represents a capitalization of reinvested earnings of the corporation, for, from an accounting point of view, a stock dividend results in the transfer of the amount of dividend from the surplus account to the capital stock account. The result from the shareholder's standpoint is the same as though he were paid a cash dividend and then compelled to invest this dividend in additional shares of stock in the company. Probably the primary reason for paying a stock dividend is the desire on

the part of the directors of insuring the retention of accumulated profits in the business. Stock dividends do not increase the equity of the stockholder; rather, they leave it the same. If he sells the stock which he received as a stock dividend, he parts with a portion of the equity he had in the business before the payment of the dividend. Usually the price of the stock declines proportionately upon the payment of stock dividends. A share of stock selling at \$120 before the payment of a 100 per cent stock dividend should in theory decline to approximately \$60 upon payment. If, however, the corporation is able to maintain the same cash dividend per share that it customarily paid prior to the declaration of the stock dividend, the stock will advance in price because of the desirability of its immediate cash return. Sometimes where it is possible to support the market for the stock, or where the stock enjoys an active demand, there may be little or no decline. Stock dividends are not taxable as income under the Federal Income Tax Law by virtue of a decision of the Supreme Court of the United States.¹ The practical effect, therefore, of stock dividends is to withhold permanently from the stockholders the amount of earnings so capitalized.

Among the reasons for paying a stock dividend is that of pacifying stockholders who, if they did not receive any dividend, would be discontented. Corporations may also wish to increase the stock outstanding for the purpose of making the dividends appear smaller through being distributed over a greater number of shares.

There is no doubt that stockholders regard stock dividends with almost as much favor as cash dividends. They do not seem to realize that a stock dividend represents a mere division of the stockholders' equity in a corporation into a greater number of units. From the standpoint of corporations, a stock dividend may point the way to a permanent retention of earnings for the purpose of expansion. It means practically the same thing as obtaining new capital from the stockholders in the amount of the stock dividend, and eliminates the expense of having to conduct a marketing campaign. The corporation's directors should

¹ *Eisner v. Macomber*, 152 U. S. 189.

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not, however, declare stock dividends without bearing in mind the fact that the tendency will be to increase the aggregate amount of dividend disbursement which will be necessary to keep stockholders satisfied.

3. *Scrip dividends*.—Sometimes companies have sufficient earnings to justify a dividend and sufficient cash to pay it in cash form, but do not do so because they believe it expedient to conserve the cash in the business for a certain period of time. Also, they may withhold the payment because of a temporary lack of cash. In such cases, resort is often made to the *scrip dividend*, which is the payment in scrip of a dividend, or the company's promise to pay. The scrip usually bears a definite date of maturity or payment, but this date may be contingent. Sometimes the payment is left to the discretion of the board of directors, and in such cases it must, under the law, be paid within a "reasonable time."

The scrip is sometimes interest bearing and sometimes non-interest bearing; and it really consists of promissory notes of the company. It is transferable, and is frequently used in transactions on the exchanges. The declaration of scrip dividends, however, is comparatively rare.

4. *Bonds used as dividends*.—A very rare practice is to issue bonds to the amount of the proposed dividend in the place of cash and to keep the latter in the business. This practice serves very much the same purpose as a scrip dividend, except that it postpones the time of the payment to a more distant date and gives the holder of the bond a stronger claim against the company than he would obtain through the scrip.

5. *Property dividends*.—Property which is unnecessary in the conduct of the business, and which is in divisible and distributable form, may be divided among stockholders as a *property dividend*. This kind of dividend is quite unusual and, when resorted to at all, is generally in the form of securities of subsidiaries owned by the distributing company.

—*Extra dividends*.—Because of the adding to the surplus each year of a portion of the net earnings of the company, the occasional transferring back to the surplus of some un-

necessary reserve, the receiving of donations to the surplus, and other similar causes, the surplus of prosperous companies often becomes considerably larger than is necessary or desirable. In such cases, the surplus is reduced to normal size by distributing to the stockholders as dividends the amount in excess of the requirements. Dividends of this type are, of course, in excess of the regular or customary dividends, and should always be carefully classified and labeled *extra dividends*. If the current earnings for any particular year justify the payment of a 7 per cent dividend, which is the normal rate of a company, and it is desired to distribute an amount from the accumulated surplus sufficient to amount to an additional 10 per cent on the stock, it would be a mistake simply to declare a dividend of 17 per cent. This would not only interrupt the regularity of the size of the dividends, but often would cause dissatisfaction among stockholders who might expect continued large dividends. By declaring a regular 7 per cent dividend and an extra dividend of 10 per cent, so labeled, a company eliminates both of these sources of probable difficulty. The distribution of a large surplus in extra dividends is frequently known as *cutting a melon*.

Financial factors affecting declaration of dividends.— Before declaring dividends, directors should consider carefully the effect the payment of the dividends will have upon the business. The payment of cash dividends reduces cash which would otherwise be available for working capital. Much, also, depends upon general economic conditions. If it appears that the business is entering upon a period of depression, conservatism should be followed, for the business may need all of its cash resources to carry it safely through the period of decline until its sales increase.

A business which is expanding may find it expedient to finance the greater part of its expansion out of its earnings; such a decision will mean that dividends must be kept at a minimum. The vast expansion of the United States Steel Corporation was largely made possible through the very conservative dividend policy which marked the financial management of the late Elbert H. Gary.

Care should be exercised by directors to always make sure

that there really is a surplus; that is, that all necessary reserves have been set aside and that the surplus has been derived from sources properly available for dividends.

↳ **To whom do dividends belong?**—Dividends belong to the holders of the stock of the company in proportion to their holdings. This amount, however, may be regulated by contract, as it is in arrangements to pay special preferential rates to preferred stocks. Generally, though, stock changes hands often; and, where the same shares are held by several persons during the course of a dividend period, there arises the question: To whom, of these several holders, does the dividend belong?

When a dividend is decided upon, a company will usually announce a date for the closing of the transfer books or, if the books are not closed, a date upon which a list of stockholders will be prepared. Stockholders whose names appear on the books of the company as holders of stock are the ones to whom the company will send the dividend. If a person owned certain stock on this date but did not have it in his name on the books of the company, he would not receive the dividend check from the company; he could, nevertheless, claim it from its recipient—the person whose name was on the company's books at the time the dividend list was compiled. In other words, the actual owner of the stock on the day of the closing of the books, or the making up of the dividend lists, is entitled to the dividend; but the company has discharged its full liability when it sends dividends to those whose names appear as owners on the books at that date, whether they are the actual owners or not.

When a share of stock sells close to the record date, the question arises as to whether the seller or buyer is entitled to the dividend. The rule of the New York Stock Exchange (*Constitution and Rules of the Board of Governors*, effective May 16, 1938, Rule No. 210) is the commonly accepted practice relative to ownership of dividends in these circumstances.

Regular-way transactions in shares are ex-dividend on the full business day preceding the record date fixed by the corporation. Regular-way delivery means that securities are purchased for delivery on the second full business day after

the date of the contract. The seller whose name is recorded on the books of the corporation receives the dividend and accordingly the amount of the dividend is deducted from the price paid by the buyer.

In the case of cash transactions, which require delivery on the date of the contract, however, securities become ex-dividend on the day following the record date. If, for example, a corporation closes its transfer books on May 21, all stocks to be paid for and delivered that day are sold cum-dividend, since the buyer has time to have his name registered as owner before the expiration of the record date. Upon rare occasions, the New York Stock Exchange may permit a stock to sell cum-dividend after the record date. This means that the buyer is paying a price which includes the dividend, even though the corporation pays the dividend to the seller. In such circumstances, the seller is required to furnish a due bill stipulating that the dividend belongs to the buyer.

As soon as a dividend is declared, provided there is an adequate surplus, it becomes a debt of the company to the stockholders; and if the company should fail before the payment of the dividend, the stockholders would, in respect to the dividend due, take position with the other unsecured creditors of the company.

If, at the time of the declaration, a fund is set aside to pay the dividends, this fund becomes the property of the stockholders, and they have first claim upon it even in case of a failure of the company.

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Questions for Study and Review

1. Distinguish between *income from operations*, *income from outside operations*, and *other income*.
2. What three remedies are suggested when it is found that the operating ratio is too high or the margin of safety too narrow for the efficient transacting of a business, and which, ordinarily, is likely to be most feasible?
3. State five reasons why a stable income is desirable.
4. Define *depreciation*, and distinguish between *deterioration* and *depletion*.
5. What is meant by the depreciation policy of a business? Why should the maintenance policy be considered in a study of the depreciation policy?
6. Describe three methods by which the annual depreciation charge may be determined.
7. What is meant by surplus?
8. State nine sources of surplus, and indicate in each case whether or not the surplus so obtained should be used for dividend payments.
9. State nine purposes served through setting up reserves.
10. State five forms which dividend payments may take.

Problems

1. Elaborate the chart on depreciation (page 276) by giving an industry that is illustrative of each type of depreciation listed.
2. Compare the dividend policy of the General Motors Corporation with that of the United States Steel Corporation over the same period of years.
3. Explain in detail the conditions under which you would recommend the declaration of:
 - a. A stock dividend.
 - b. A scrip dividend.
4. On May 1, the board of directors of the Marden Manufacturing Company, Inc., of Brooklyn, N. Y., met and declared a dividend of 6 per cent on all stock of the company as of May 15,

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payable June 15. Mr. Alden was the owner of 50 shares of this stock on April 30, and sold it on May 5 to Mr. Babcock, who sold it to Mr. Cutchens on June 1. Who is entitled to the dividend?

Suppose Mr. Babcock had sold it to Mr. Cutchens through the New York Stock Exchange on May 15. Who would receive the dividend and why?

5. At the end of its first fiscal year the New Furniture Co., Inc., presents the following condensed statements:

BALANCE SHEET

Cash.....	\$ 6,160.00	Notes Payable.....	\$ 2,200.00
Accounts Receivable..	10,450.00	Accounts Payable....	12,320.00
Inventories.....	9,240.00	Accrued Wages.....	880.00
Plant and Machinery..	17,050.00	Capital Stock.....	22,000.00
Patent Rights.....	5,500.00	Surplus.....	11,000.00
	<u>\$48,400.00</u>		<u>\$48,400.00</u>

INCOME AND EXPENDITURES STATEMENT

Gross Sales.....	\$61,600
Deductions from Sales.....	<u>2,420</u>
	\$59,180
Operating Expenses.....	<u>34,320</u>
Manufacturing Profit.....	\$24,860
Selling Expenses.....	<u>9,570</u>
Gross Profit.....	\$15,290
Administrative Expenses.....	<u>3,300</u>
	\$11,990
Taxes and Other Deductions.....	<u>990</u>
Current Earned Surplus.....	<u>\$11,000</u>

These figures are accepted as truly representing the company's condition and record for the year. The prospects are that the coming year's business will be equally good. One of the directors favors the declaration of a 20 per cent cash dividend; another favors the declaration of a 40 per cent stock dividend; a third favors the paying of no dividend at all.

Assume that you are a director and a large stockholder and are called upon to express your opinion. Review briefly the factors you would take into consideration, state your opinions, and itemize the arguments you would use to support your opinions.

CHAPTER XVI

Investment of Funds

Investment defined.—Stripped of its many finely shaded distinctions, *investment* is basically the placing of funds into a business to be used as capital, on account of an expectation of payment for their use, either in the form of definite interest or in the form of a share of the profits; or, it may be the lending of funds to some civil body, such as a national, state, or city government, on account of a promise of interest payments.

Thus, an investment may be made by purchasing the bonds of any civil unit, or by purchasing the bonds, or stock, or other securities of any business whatever.

In other words, money has what may be called a *rental value*: those who can use it profitably are willing to pay for its use; and those who have money which they are unable to utilize for profit-making purposes will generally turn it over to, or invest it with, others who are willing and able to use it and to pay for the privilege of doing so.

Almost the entire business and economic structure of today is built up on the willingness of hundreds of thousands of persons of comparatively small means to turn over their savings to be used by the business activities of the country. The small individual investments of the multitudes aggregate the tremendous capitals of our big business concerns.

Idle money earns nothing and, except upon occasions where it is held for necessary reserves, serves no useful purpose; but money invested in a sound industry, railroad, utility, or other economic activity, or lent to the Government, not only earns an income for its owner but helps to produce active and prosperous conditions.

Investment and speculation.—*Speculation* in the financial field, as well as investment, is the utilization of funds to pur-

chase business securities. The question is: what is the difference, and where is the dividing line, between the two. As a matter of fact, the difference can be stated in general terms only, and no absolute line of demarcation can be drawn. It is commonly understood that the investor usually seeks safety of principal and is satisfied with a comparatively small return if safety is assured; also, that his primary motive in investing is to place his funds for a considerable term and to take as his profit the regular periodic returns. The speculator, however, is generally understood to be willing to take a greater risk provided there appears to him to be an opportunity for greater gain; moreover, many speculators count for their gain upon a quick resale of their securities at a capital profit rather than upon a long hold for the interest or dividends.

Some believe that bonds only form the basis for investment, while all stock purchases are speculative. Nevertheless, many stocks are safer and sounder than many bonds, and possess more investment features than do the latter.

While a large number of speculative operators are so well experienced and possess such great ability in their fields that their profits are very great, and generally consistent, yet it is held by most students of the subject that the profit from investment, as a whole, is much greater than that from speculation, in which the profits of the few are more than offset by the losses of the many who are not sufficiently skilled to play the game successfully.

Speculation does not necessarily mean the buying of unsound securities; it means, rather, the buying of those whose worth has not been proven or established. They may turn out to be a loss, or they may prove very valuable. The speculator feels that he can take the chance, the investor does not. Thus, speculation provides a valuable market for many securities which could never be marketed to investors, and the speculative buyers have been responsible for the initial financing of many businesses which have turned out to be sound and valuable.

There can be no particular quarrel with the person who has free funds and desires to use them speculatively; but the

person who cannot afford to take a loss, or who is dependent upon the income from his money, or who is handling the funds of others, is never justified in taking the chance involved in a speculative deal. Sound investments must be his only financial activities.

Investment can be placed upon a very sound basis, and quite safe rules and regulations can be established; however, every speculator is a rule unto himself, and the art of speculation cannot be placed upon even a quasi-scientific basis.

The investment of business funds.—As may be remembered from discussions in earlier parts of this text, businesses do not always distribute their entire profits as dividends to the stockholders.¹ Portions each year are usually held in various reserves, and portions are often carried to the surplus. A certain amount of surplus is a necessity and a distinct advantage to a business, but often a surplus is built up considerably in excess of what the business needs or can use to advantage in its own activities. If such unnecessary surplus is simply retained as idle funds, it is a very apparent waste, and so the question arises as to how best to dispose of it. Sometimes such excess surplus is divided among the stockholders as extra dividends. Often, however, it is deemed wise to place it in sound income-producing securities and to use the yield either for dividend purposes or for building up a still greater surplus for additional investments. There is, of course, great diversity of opinion as to which is the better policy; but, after all, this decision must depend upon the actual conditions and circumstances attending the particular individual business concerned, and it must be determined by the directors in their general policies concerning the management of income and the distribution of profits.²

This chapter will not deal with the *expediency* of the investment of surplus funds, but will discuss merely the methods and principles used in case an investment policy is decided upon.

Investment characteristics.—Not all investments are alike, but there are certain characteristics which every in-

¹ See Chapter XV.

² See Chapter XV.

vestment is supposed to possess to some degree. The chief attributes are *safety of principal, certainty of income, size of income, and marketability.*

Besides these, there are such secondary considerations as *taxibility or tax exemption, desirable duration or life of the security, and satisfactory denominations.* The truly ideal investment would offer absolute safety of principal, positive assurance of regular income at a satisfactory rate, immediate marketability at a good price at any time; it would be free of taxes and would be of just the duration and denomination which the individual investor desired. But a lifetime of search would probably never disclose such an ideal in actual existence. The individual investor, therefore, selects the securities which come nearest to possessing all of these good qualities in the proportions which he desires. A fair assurance of a large and steady income will often cause many investors to relax somewhat their demands for absolute guarantee of safety of principal, while others will always demand the maximum degree of safety regardless of how small the yield may be.

The investment of corporate surplus funds is, however, quite a different matter from the investment by an individual of his own funds. The funds which the corporation has to invest consist of earnings which have been held back from distribution to the stockholders; they constitute a surplus which is really the undivided property of the stockholders and which the directors must, in their fiduciary capacity, guard with the utmost care. Safety of principal must always be the first and foremost consideration in the investments of corporate funds, and marketability must be the next. Any other feature which might be possessed at the expense of these two must be disregarded. It is much better to keep a surplus idle, with no earnings whatever, than to lose it through an unsafe investment. Marketability is highly necessary, for one can never foretell accurately when the invested surplus may be urgently needed in the business, and if it is frozen in some unmarketable investments the corporation is as bad off as if there were no surplus available. Safety and liquidity, therefore, must outweigh all other considerations in the investing of corporate funds. Of course,

if safety and marketability can be obtained together with assured large income and other desirable features, well and good; otherwise, everything must be sacrificed to these two.

Since this text deals with the topic of business finance and not the subject of investments, and since investments as a whole cannot be even lightly outlined in one chapter, the remainder of this chapter will be devoted to the discussion of how corporate managers can best assure themselves of safety and marketability in investing the corporate funds and what investments of various types offer in these two respects.

Methods of assuring safety of principal.—The strongest and most prosperous business of today may, through some mischance or some uncontrollable condition, be a total failure and loss ten years from now; even strong governments may totter and fall. Likewise, there can be no *absolute* assurance of safety for any investment, especially one for a long term. Nevertheless, *practically* riskless investments can be made through observing conservative practices. The practices which, through many years of investing experience, have been established as those tending most surely toward safety may be stated as follows:

1. Consider only sound government bonds and other high-grade public bonds and well-secured high-class bonds of thoroughly sound corporations; or, if any stocks are purchased, let them be only of the highest type in sound and well-seasoned companies.

2. In buying corporate securities, let the inherent soundness of the corporation predominate over every other element.

3. Arrange the most desirable diversification of securities held.

4. Select with care the types of businesses in which to invest, using only those whose economic future is reasonably assured.

Each of these four important practices will be discussed in some detail in the following paragraphs.

Bonds vs. stocks as investments.—There is an argument of long standing as to whether both bonds and stocks may be considered as investments, or whether only bonds may be

properly so classified. Bonds, of course, by their very nature, are essentially investment instruments. They offer safety of principal, secured by a lien on property (presumably of a constantly greater value than the face of the bonds); or by the credit of some civic or governmental unit; or, as in the case of industrial debentures, by the good faith and free assets of a corporation. Not only is the principal, thus, secured during the life of the bond, but there is a definite promise and pledge on the part of the issuer to repay the principal at or before maturity. The fixed interest is also practically guaranteed at regular periods, and the forfeiture for default will be the acceleration of the maturity and the right of the bondholder to foreclose. In practically all bond issues the stipulated interest rate is lower than that which would attract speculators.

Stock conveys no promise whatever to repay the principal at any time and gives no assurance that the buyer may get back the amount of money placed in it. It represents merely the purchase of part ownership in a corporation and involves all the risk of gain or loss to which such ownership is liable. The only way, normally, to recover the capital put into a stock purchase is to resell the ownership to someone else at a price equal to or greater than that paid; the possibility of doing this depends upon the present worth of the corporation and upon the current condition of the stock market. There is no guarantee or absolute promise of a definite income. Whatever earnings or profits there may be each year after the payment of all expenses and fixed charges and the putting aside of all necessary reserves, is at the disposal of the directors for dividends to the stockholders; this may be much, or little, or absolutely nothing. There are many other defects of stock to be noted when one views it from an investment standpoint, but the above-mentioned features alone are sufficient to remove stock, as it is generally considered, from the category of investments.

Despite this, however, there are certain companies of such great strength, with stability so beyond all question, with management of such a high type, with products so essential to everyday life that they fill a continuous economic need and consequently place the company beyond fear of injury

through competition, with a history of dividend payments as regular as that of the interest payments on any bond issue, and with such other desirable features that their stock is eagerly sought even by most conservative investors. This stock can rationally and practically be looked upon as an investment.

Thus, both stocks and bonds may be regarded as investments: bonds, because of their inherent nature; and stocks, only in those certain instances in which they possess true investment characteristics. In most investments of large funds, bonds constitute the great backbone of the transaction; and stocks, even of the best quality, a much smaller part.

Inherent soundness of companies.—It is axiomatic to say that no investment in corporate securities can be satisfactory unless the issuing company is inherently sound. But one must thoroughly understand what constitutes such *soundness*. There are two features which must be considered; namely, the actual value of the corporate assets and the earning power of the company.

Bonds are not necessarily secure because of the fact that they are protected by a mortgage on physical property having a present estimated value of 30, 40, or 50 per cent above the face of the bonds. If the issuing company ceases to earn, then interest cannot be paid, and the physical property may be worth very little for any other purpose than that for which it was being used. Physical property of a dying or defunct company is seldom good security for bonds.

Similarly, earning power alone does not constitute satisfactory backing for a bond issue. In order for a company to be considered inherently sound from the investor's point of view, it must show a substantial equity in physical property and also a fair earning power, which gives reasonable promise of continuing.

Diversification of investments.—One of the greatest safeguards in investment is *diversification*, that is, the placing of funds in a number of different securities of various types. If an entire investment fund is placed in the securities of one company and that company fails, it spells ruin for the investor. If, however, the fund is used to purchase securities

of a dozen or more different companies, it is not probable that all will fail, and a failure of one or two will cause a loss of only a part of the investment.

Diversification may be obtained in a number of ways, each of which helps to protect the invested funds:

Diversification through numerous securities.—The simplest method of diversification consists in merely dividing the investment fund among a large number of different securities. The greater the number of different securities held, the smaller will be the proportionate loss in the case of the failure of one or more of the companies. This method of diversification, while better than none, should not be relied upon alone, as many other types of diversification can be combined with it to advantage.

Diversification through the use of both bonds and stocks.—Many persons who like to use high-class stocks as their investments temper the risk by mixing in a considerable proportion of very safe bonds.

Diversification between public and private securities.—Government bonds usually pay very low interest rates; but, on account of their very great safety, they practically always form a considerable percentage of a well-diversified investment.

Diversification among private securities.—Even among the securities of private corporations, diversification should be practiced. Though certain economic conditions may cause depression and loss in practically all the businesses in one field, they probably will not, except in rare periods of general national or world depression, extend to all the different fields. Careful investors, therefore, will usually have in their investment portfolio some railways, several types of utilities (such as gas, electric, telephone, or telegraph companies), and an assorted lot of industrials. The more varied the business *fields* over which the investment is spread, the less likelihood is there of big losses.

Diversification geographically.—Sometimes adverse conditions affect certain localities, states, regions, or countries; in such cases, investments in securities of companies wholly within the territory so affected will become unsafe, no matter

how well they may be diversified as to types and kinds. Geographic distribution, therefore, is considered an additional and valuable safeguard. Not only do investors attempt to purchase corporate securities of companies in widely separated sections of the country, but many include even foreign companies.

Public bonds, also, are usually diversified in this manner: the investor not only takes bonds of the United States and of various states and cities of this country, but also adds European and South American national and city bonds. Of course, the wider the geographical diversification, the less chance is there of losing a large part of the investment through more or less local causes.

Diversification of bonds as to maturity dates.—The conservative bond buyer will take care to purchase various bonds whose maturity dates extend over a considerable period of time. This obviates liquidating a great part of the investment at the same time, which might be a time at which it would be very difficult, or probably impossible, to reinvest the fund under favorable conditions. By having the maturity dates spread out, the probability is almost certain that different issues will mature under different conditions, but that the average between the good and the bad times will give the investor at least as good reinvestment conditions as he had before.

Diversification as to interest and dividend dates.—As a matter of convenience, bond and stock investments are frequently diversified as to interest and dividend dates. The large investor who prefers to receive his income in large amounts at convenient intervals of time will often choose securities all of which pay at the same time, for instance, January 1 and July 1 of each year. The small investor who expects to support himself from his investment income may buy securities paying at various times so that he will receive something like an equal amount of income each month. Such an arrangement can usually be arrived at without materially affecting the safety of the investment.

Diversification not a cure-all.—In considering the many safety features which are afforded by diversification, one

must not get the idea that diversification can protect against losses from inherently weak or unsound securities. Diversification does not mean the mixing of good and poor investments, but contemplates always the most careful investigation and selection, and the purchase of only sound securities in the various fields chosen. Any diversification plan which necessitates the inclusion of securities not having the attributes of sound investments is entirely improper.³

Attributes of various types of investments.—Every type of investment has certain peculiarities or attributes which must be understood and recognized by the investor of the funds. Lives have been devoted to the study of these characteristics, and large books have been written about them; but in this brief discussion only a short résumé can be attempted. The larger and more important groups or classes will be taken up in separate paragraphs.⁴

United States Government bonds.—Bonds of the United States Government are generally recognized as being as nearly free from risk as it is possible for any bonds to be. Such bonds have been issued by the billions of dollars worth, and there has never been a default in interest or principal. All government issues are essentially debentures, in that they are not secured by a claim or lien on any actual property but only by the good faith and credit of the government itself, and its ability and willingness to pay. The paying ability of the government is established by its taxing power, which is unquestionably sufficient to meet all the demands of the public debt. As a matter of fact, the entire public debt is only about 7 per cent of the estimated wealth of the nation, and the interest and other charges on the nation's bonds represent in the aggregate only about 3 per cent of the national income.

Government bonds pay low interest rates: some are as low as 2 per cent, and none at present more than 4½ per cent; but in spite of this they are in great demand on account of their

³ For suggested diversifications of investment funds, see: Chamberlain and Edwards, *Principles of Bond Investment*, pp. 34-36; and Jordan, *Investments*, pp. 259; 261; 262.

⁴ A more complete discussion may be found in: Chamberlain and Edwards, *Principles of Bond Investment*; Jordan, *Investments*; and Lagerquist, *Investment Analysis*.

safety. The disadvantage of low interest rates in government issues is partially compensated for by the fact that they are almost entirely exempt from income tax charges. Practically all diversified investment budgets of large investors contain a considerable proportion of government bonds. These bonds are also legal investments for trustees and savings banks.

State bonds.—State bonds, like those of the national government, are secured not by lien or claim upon property, but by the credit of the state. The state's ability to pay depends upon the adequacy of its taxing power. The wealth and taxing ability of the states are such, however, as to make the state bonds very secure and desirable investments. They are issued mostly to raise money for public improvements—such as roads, public buildings, and welfare institutions—and for state military and educational purposes; and since these needs will continue to exist from generation to generation, it behooves the citizens of the state to avoid repudiation or default on state issues in order that the credit standing will be sound for future issues.

The worth of state bonds is usually reckoned by considering the ratio of the state debt to the annual valuation of taxable property in the state, and also by considering the debt per capita.

The ratio of debt to assessed valuation in the several states runs from zero to almost 6 per cent, with an average for all states of slightly over one per cent; and the state debt per capita runs from zero to about \$95, with an average for all states of about \$12.50; so it may easily be recognized that the state bonds, as a whole, are quite conservative and well within the limits of possible payment.

There have been a few cases of repudiation of state bonds, but these were under great stress of panic or civil war, and there is little possibility of any repudiation under present conditions or under conditions which seem liable to arise in the calculable future.

State bonds are exempt from the federal income tax and also from state and local taxes, except taxes on estates in the state of issue. They are usually issued and paid off as serial bonds or else redeemed by the use of a sinking fund, and thus

distribute the burden of payment over a long period of time. They are popular and generally sound investments, and are found in most large portfolios.

Municipal bonds.—Many municipalities, such as cities, towns, counties, and special districts, borrow money for their roads, water supplies, sewers, schools, and many other purposes through the issuance of municipal bonds. These, like national and state bonds, depend for their interest and repayment upon the taxing ability of the issuing municipality and are, therefore, judged largely by the ratio between the bonded debt of the municipality and its taxable values. They differ from national and state bonds, however, in that a default or repudiation in municipal bonds may give the holders the right to sue the municipality and procure court orders compelling it to impose taxes sufficient to meet its obligations. Thus, municipal bonds may be said to be secured indirectly by the physical property of the municipality. Occasionally, municipal bonds are issued without adequate statutory authority, or not in exact accord with statutory requirements, or in excess of the prescribed debt limit. In these cases the issues are rendered illegal. Such illegality of issues must be carefully guarded against by the investor. As a matter of fact, almost all municipal bonds are originally bought in large lots or in their entirety by big investment banking houses who make all necessary investigations and leave the ultimate small purchaser comparatively safe. Municipals pay a higher rate than either national or state bonds, and since they are generally exempt from the federal income tax and from the income tax of the state in which they are issued, they are quite desirable investments. Most states, also, make their municipal bonds, with certain small restrictions, legal investments for savings banks and trustees; this practice assures to them another large market. In normal times they usually bring to the issuer a price somewhat above par.

Foreign public bonds.—Foreign nations, states, and cities issue various bonds for public purposes; but until very recent years, the bonds have not been widely purchased by American investors, mainly for the reason that their rapidly developing domestic industries and the domestic civic bonds

utilized at favorable terms practically all of their available capital. More recently, however, a tendency has developed to invest some American capital abroad on account of good returns and international diversification. The greatest drawback to foreign investments is the difficulty that the ordinary investor has in obtaining necessary information to keep posted regarding his investments. Foreign investments depend for their income and for the safety of their principal not only upon the taxing ability of the issuing nation, state, or city, but also upon the probability of the continuation of sound conditions and the improbability of political changes, war, or revolution, which are considered negligible factors in American public securities. Another undesirable feature of many foreign bonds is that they are issued in terms of foreign monetary units, which are not only unfamiliar to the American but which may, and often do, so fluctuate in exchange value as to render the interest yield and the principal amount very uncertain. In recent years, a number of foreign external bonds intended for American consumption have been issued on a dollar basis; both the interest and the principal amount have been expressed in American dollars. This provision, of course, eliminates the risk involved by the fluctuation of foreign currency.

The average investor who desires to invest in foreign civic bonds for any reason whatever is dependent upon some source other than himself for adequate information; this inconvenience deters many from making such investments. A few bond houses specialize in foreigners and can give information concerning them; but since they have the bonds for sale, such information may not always be disinterested.

Much excellent work in reporting and analyzing foreign conditions bearing upon foreign securities is being done by the Institute of International Finance conducted in New York City by New York University.

Railroad securities.—For years senior railroad bonds have been generally considered, next to government bonds, the safest and soundest of investment securities. The railroads constitute the largest single industry in the country, with the exception of agriculture; and their importance, both on ac-

count of their size and the indispensable service which they render, makes it imperative that they be protected and kept solvent and active. To this end, the government exercises a broad regulative policy authorized by many legislative acts (principally the Transportation Act of 1920) and administered by the Interstate Commerce Commission. This commission is charged with, among other things, fixing railroad rates for the best interest of both the carriers and the public. Under the law, the rates so established must be such that the roads, as a whole, will earn an aggregate annual net operating income equal (or as nearly equal as possible) to a fair return upon the aggregate value of the railroad property held for and used in the service of transportation.

The initiative in rate changes may be taken by the Commission itself, or it may act upon a petition of the railroad, of the shipper, or of consignees.

The valuation of the railway property upon which the fair return is allowed is also determined by the commission; the intent of the law is that such valuation shall be the actual physical value of such property.

Besides these governmental attempts to assist the railways, as a whole, in maintaining fair earnings, the law also provides that the Interstate Commerce Commission shall have control of all new security issues and shall see that every issue is reasonably necessary and appropriate. This precaution affords the investing public protection against overexpansion and such wild financing as the railroads were guilty of some half century or more ago. Recent legislation has also provided for reorganization of railroads under its direction.

The government contemplates the eventual consolidation of the many roads into a few groups or systems, of comparatively equal strength, which it is believed will tend toward greater stability for all.

At the present writing, the railroads, like practically all other businesses, are greatly depressed. Operating costs are still high and traffic is small, so that both gross and net profits are very low. The absolute necessity of the railway systems to the very existence of the country is, however, so well

understood by both the government and the public at large that the holders of senior issues probably will not suffer.

Public utility securities.—Public utility companies not only sell services which are public necessities, but, by their usual monopolistic franchises, they are also protected in their work against injurious competition. They operate in all states, except Delaware, under the supervision of state Public Utility Commissions, which prescribe the service they must render and fix the rates they may charge. The rates are such, presumably, as will produce a fair rate of earning on the capital used in the business. All of these factors tend to produce regular and stable earnings in well-managed utilities and cause their securities to be very popular investments.

Equipment trust obligations.—These notes or bonds are secured by a claim on the equipment of such a value as to always provide ample equity for the protection of principal. The equipment forming the security for these obligations is held by the railroads or other utilities, only upon lease or conditional bill of sale, and is so vital to their operation and very existence that they cannot afford, under any circumstances, to permit a default and a seizure of the property.⁵

There are numerous cases in which railroads have become involved in financial difficulties, or have gone into receivership, or have gone through reorganizations, to the considerable detriment of their regular bonds and stocks, though their equipment obligations remain fully cared for and unimpaired. The cases of default are few indeed, and the railroad equipment trust loan may be looked upon as one of the very safest forms of investment known in financial circles.

Industrial securities.—*Industrial securities* is the very general and inclusive name applied to the securities of every kind of business other than railroads and utilities. They cover so many fields and so many types of businesses that only the most general kind of rules concerning their use as investments can be given in a brief discussion.

While there are many very strong industrial securities well suited for investment purposes, it is, nevertheless, true that, as a class and in their entirety, industrials rank low in the

⁵ See Chapter X for details concerning these trust obligations.

investment field. Their charges are not regulated, as are those of railroads and utilities; thus, industrials are free to fix their own rates. The result is that they often take advantage of conditions and make huge profits. But this lack of regulation also gives them a free hand in the issuance of new securities and makes overcapitalization, by means of both stocks and bonds, possible and frequent. They require no franchises, as do utilities; hence, the various fields are open to all. This condition results frequently in overcrowding and ruinous competition. Earnings naturally fluctuate greatly with business conditions and often render both dividends and bond interest uncertain. For these and other reasons, industrials require a most searching investigation before any investment is made in them.

In the investigation of industrials there are a number of considerations which must be kept in mind, the principal of which are as follows:

1. *Nature of the business.*—Businesses producing or dealing in substantial products, necessities with a wide and lasting demand, are naturally more stable and reliable than those producing non-necessities, luxuries, or goods with a temporary demand.

2. *Capitalization.*—The financial plan or financial set-up must be carefully studied to guard against overcapitalization or undercapitalization, and especially against an overpreponderance of funded debt with its attendant fixed charges. The total capitalization should be, of course, as near as possible to the amount upon which the business can earn an average annual income at a fair rate. The ratio between stocks and bonds cannot be fixed for all businesses; but a general rule agreed upon by most authorities is that bonds should not exceed an amount upon which the interest charges will be more than one-third of the average net income of the company, or, stated in another way, the average annual net earnings should be at least from two and a half to three times the fixed charges. The actual ratio of bonds to stocks in leading industries runs from zero to about 50 per cent, with the average around 10 per cent.

3. *Efficiency of management.*—An efficient management

requires a combination of ability and integrity on the part of the managers. Management operating through the use of capital produces corporate earning power. A highly efficient management can frequently overcome many handicaps, such as improper capitalization, undesirable products, poor plant location and equipment, and so on; whereas, a poor management frequently permits the failure of a business which is otherwise endowed with every advantage.

4. *Earning power.*—The average annual earning power over a number of years is probably the essential test of the soundness of any business and the safety of its securities. This earning power, as noted above, really reflects accurately the effect of the management working upon and through the company's capital. It is the earning power which renders a company able to pay its periodical interest charges and to continue in business long enough and prosperously enough to pay off bond principal at maturity, and it is quite as important as physical assets in estimating the desirability of a bond.⁶

5. *Balance sheet disclosures.*—From the study of a properly prepared balance sheet, there can be determined the company's evaluation of its tangible and intangible property, its total assets, its liabilities, its surplus, and its capitalization in both bonds and stocks. From it can be determined, also, the book value of the company's stock, its working capital, and its current ratio, all of which should be given due consideration.

6. *Income statement disclosures.*—The income statements for several years should be studied and compared. The gross operating revenue can be analyzed as to both size and stability. By comparing the operating expenses with this, one can ascertain the operating ratio. This should be as low as practicable and rarely over 90 per cent. The fixed charges are definitely shown; and by comparing these with the amount available for fixed charges, and the results with

⁶ A valuable and interesting discussion of the importance of earning power (the resultant of assets operated upon by management) is to be found in Dewing, Arthur S., *The Financial Policy of Corporations*, pp. 103, 140-142, 306-310, 312-328; and also in briefer form in his smaller work, *Corporation Finance*, pp. 39-40, 50-54.

such standards as those indicated in the table on page 315, one can ascertain whether these charges are earned by a safe margin.

Real estate mortgages.—Many persons regard real estate as one of the most basic and stable forms of wealth and value; hence, they consider that money directly loaned and secured by a good mortgage on desirable real estate is very safely invested. In lending on real estate mortgages, one must determine whether the mortgagor's title is sound, whether the mortgage is properly drawn, whether there is ample equity on the basis of a sound valuation, and whether sufficient margin has been allowed for a possible decrease in the value of the security. It is generally considered safe to lend on a real estate mortgage up to two-thirds of the fair valuation of the property. Savings banks, insurance companies, and other large financial institutions are big investors in real estate mortgages.

Real estate mortgage bonds.—Large real estate mortgages are frequently divided among many investors by means of placing the mortgage in the hands of a trustee and issuing a number of bonds under it, in a manner similar to the operation of corporate mortgages. These bonds comprise a popular form of investment, but great care must be taken by the investor to be sure that he receives a fair and accurate appraisal of the property. In lending on an entire real estate mortgage, the lender has ample opportunity to have the property appraised by his own appointee and the appraisal carefully checked; but when an investor buys only a few of a large issue of real estate mortgage bonds, he is usually constrained to accept the valuation of the issuer. Many large building and development corporations and real estate holding companies operate entirely by selling real estate mortgage bonds under mortgages on their projects. Valuations are made by appointees of the companies, and whether or not their valuations are fair and sufficiently conservative is a very difficult matter for the investor to check.

Farm mortgages.—Loans to farmers secured by mortgages on farm lands constituted for many years a favorite form of investment for both individuals and institutions.

They were somewhat uncertain, as the real value of farm land as security for loans was difficult to fix. Since 1916, the Federal Land Banks and the Joint-Stock Land Banks have been taking care of the greater part of the farm loans, and they are disappearing from the budgets of business houses.

Generally accepted ratios.—A complete set of factors and ratios to be applied as a yardstick for the measurement of any proposed investment would be most useful; but such could not, on account of the almost numberless conditions and probabilities, be devised. Investment analysts, however, make use of certain ratios for comparative purposes in testing the safety of securities.

Naturally, the most satisfactory test of the safety of any security is the relationship of the interest or dividend requirements to the amount of annual earnings available for this purpose. To judge securities properly on this basis, a single year is inconclusive, and an average for a number of years, at least five, should be taken. The table given below presents a summary of accepted ratios for railroad, public utility, and manufacturing corporations. These ratios must occasionally be adjusted to meet changing conditions and trends. Some discussion of these ratios has already been given in the chapter "Capitalizing the Corporation," on pages 201-203.

MAXIMUM RATIOS

<i>Item</i>	<i>Railroads</i>	<i>Public Utilities</i>	<i>Manufactures</i>
Value of Property:	Four times gross revenue.	Five times gross revenue (except water and hydroelectric).	Average net earnings capitalised according to nature of business.
Gross Revenue:	Base.	Base.	Base.
Operating Expenses:	72-75% of gross revenue (including taxes).	65% of gross revenue (including taxes).	80-90% of gross revenue.
Net Revenues:	1.5 times fixed charges.	1.75 times fixed charges.	3 times fixed charges in poorest year.
Fixed Charges:	12% of gross revenue.	12% of gross revenue.	5% of gross revenue.

The operating ratio and earnings coverage.—There are certain fundamental tests which an investor may apply to the income statement of a corporation which will assist him

in determining the efficiency with which the corporation is being operated and the investment quality of its securities. The method by which these tests are applied may best be illustrated through the use of a simplified income statement, such as that immediately following.

STATEMENT

Gross Operating Revenue	\$1,500,000 (A)
Operating Expense	900,000 (B)
Operating Profit	600,000 (C)
Interest 1st Mortgage Bonds	200,000 (D)
	400,000 (E)
Interest 2nd Mortgage Bonds	40,000 (F)
	360,000 (G)
Interest Debenture Bonds	60,000 (H)
	300,000 (I)
Preferred Stock Dividend	100,000 (J)
Available for Common Stock and Surplus	\$ 200,000 (K)

Operating ratio.—This ratio is designed to measure the efficiency of the operating management. It is the ratio of the operating expenses to the gross operating revenue derived from operation. In the above statement, it will be the ratio of Item B to Item A, and is expressed as:

$$\frac{B}{A} = \frac{900,000}{1,500,000} = \frac{90}{150} = 60\% = \text{Operating Ratio.}$$

This means simply that for every dollar received through the operation of the business, 60 cents has been expended in operation costs. This ratio should be kept as low as possible while still being consistent with the efficient operation of the business. Since, however, many of the expenses of operation are fixed, it is usually impossible to reduce operating expenses in proportion to the decline in gross revenue. The converse is also true; that is, increases in gross revenue may not be accompanied by proportionate increases in operating expenses. The operating ratio in most cases, therefore, may be expected to be higher in times of business depression than under usual conditions.

Earnings Coverage.—In measuring the safety of bonds and preferred stock, the usual practice is to reduce fixed

charges and preferred stock dividends to what is termed a *times earned* basis. The number of times interest and preferred dividends were earned is determined as follows:

For the first mortgage bonds:

$$\frac{C}{D} = \frac{600,000}{200,000} = 3 \text{ times.}$$

For the second mortgage bonds:

$$\frac{C}{D + F} = \frac{600,000}{200,000 + 40,000} = 2\frac{1}{2} \text{ times.}$$

For the debenture bonds:

$$\frac{C}{D + F + H} = \frac{600,000}{200,000 + 40,000 + 60,000} = 2 \text{ times.}$$

And for preferred stock dividends:

$$\frac{C}{D + F + H + J} = \frac{600,000}{200,000 + 40,000 + 60,000 + 100,000} = 1\frac{1}{2} \text{ times.}$$

It will be observed that cognizance is taken of the prior claim of the senior bonds over the junior bonds and preferred stock. This method of calculating the earnings coverage of the various issues is known as the "over-all" basis and should be rigidly followed. Its application in the analysis of a financial plan has already been discussed in Chapter XII.

Marketability.—As stated earlier in this chapter, marketability is one of the prime requirements of securities for business investment portfolios. The ideal market for investment securities is wide, active, and strong; and in buying securities one should take precautions to procure only those which will have such a market in so far as that is possible.

The very first attribute of marketability in any security is that it be sound and safe both as to principal and yield, and that it be such a security as any other conservative investor would desire to have in his budget.

A wide market is more readily obtained by purchasing securities which are part of a very large issue, for this gives them wide distribution and makes them known and dealt in over extensive territory.

Diversification of securities aids in marketability just as it does in safety, for lack of demand for one or more securities will not greatly affect the demand for an entire widely diversified list.

Prospects of extra dividends, stock dividends, issuance of rights, or increased market value for any reason, cause an active market for stocks. Persons who buy actively for these reasons are largely speculators, and thus speculation is a direct aid to the marketability of investments. Probable redemption at a premium or at par when the market is less than par, a dropping of current interest rates below the fixed rate of a particular bond, or the expectation of an increase in market price for any reason, will bring about an active market for a bond issue.

A dividend record that has long continued at a favorable rate will maintain a strong market for stocks. Inherent soundness, with an interest rate slightly above that at present obtainable, tends to create a strong market for bonds.

Conversion privileges, under certain favorable conditions, will often bring about an active and strong market for convertible stocks or bonds, but such a market is generally of short duration, ceasing after the immediate desirability for conversion has passed.

Listing on active exchanges is an aid to the marketability of securities. Listing will not produce marketability for undesirable stocks, but of several equally desirable securities, those listed will normally find purchasers more readily than those not so listed. However, listing on the exchanges must not be valued too highly; it simply assists in the sale of securities by placing them where buyers congregate. Unlisted stocks and bonds with desirable attributes will be readily sold while undesirable listed stocks find no purchasers whatever.

Security markets.—Organized stock exchanges exist in various parts of the country upon which securities may be bought and sold. On these exchanges, only those securities which have been officially admitted to trading may be bought and sold. The City of New York possesses two exchanges: the New York Stock Exchange, which is the most important securities exchange in the United States, and the New York

Curb Exchange. All securities on the New York Stock Exchange are listed, that is, the corporations have made formal application to have their securities admitted to trading and the exchange has granted the privilege. The New York Curb Exchange formerly had provision for two types of securities: those which were listed and those which were admitted to unlisted trading privileges. Under rulings established by the Securities and Exchange Commission, since 1934 no securities are admitted to unlisted trading privileges. The exchanges require that corporations whose securities are listed comply with their rules with respect to the issuance of periodical financial statements to their stockholders and such further regulations as may be prescribed by the listing committees of these exchanges and the Securities and Exchange Commission which was established by Congress in 1934 to regulate exchanges throughout the United States.

Another important security market is what is known as the over-the-counter market. This is more or less an unorganized market and is made effective through telephonic communications among over-the-counter brokers in contrast to the operations on the exchanges where members meet in a central place to transact their business. Some types of securities, notably those of financial institutions and municipalities, are traded in on the over-the-counter market much more extensively than through the organized exchanges.

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Questions for Study and Review

1. Explain what circumstances induce the investment of funds.
2. Discuss and compare *investment* and *speculation*.
3. Why should corporate directors exercise greater care in the investment of corporate funds than the average individual investor may deem necessary in his personal investments?
4. Explain the supreme importance of safety and marketability in corporate investments.
5. Name four established practices which tend to produce safety in investments.
6. Contrast bonds and stocks as instruments of investment.
7. What is meant by the inherent soundness of a business corporation?
8. *a.* What is meant by the phrase *diversification of investment*?
- b.* Name and explain at least five methods of diversification.
9. Discuss the investment features of:
 - a.* United States Government bonds.
 - b.* State bonds.
 - c.* Municipal bonds.
10. Discuss the investment features of:
 - a.* Foreign public bonds.
 - b.* Railroad securities.
 - c.* Public utility securities.
 - d.* Equipment trust obligations.
11. Why do industrial securities require a most searching investigation on the part of the investor?
12. Discuss six important considerations which must be kept in mind when investigating industrial securities with a view to investing in them.

13. Discuss in detail from an investment point of view:

- a. Real estate mortgage loans.
- b. Real estate mortgage bonds.
- c. Farm mortgages.

14. Discuss the several ratios of property valuation, operating expenses, net revenues, and fixed charges, as stated on page 315.

15. Name and discuss at least five circumstances or conditions which tend to aid in the marketability of investments.

16. What advantages may be derived from listing securities?

17. Distinguish between the work of the New York Stock Exchange and the New York Curb Exchange.

Problems

1. Assume that the simplified income statement on page 316 represents a normal year of operations. In a poor year, gross revenue decreased ten per cent and operating expenses also decreased, forty per cent of them decreasing in proportion to the decrease in gross revenues, and the other sixty per cent remaining stationary. Compute the following ratios, indicating the investment quality of the securities in the poor year:

- a. Operating ratio.
- b. Times the fixed charges on each of the three mortgages were earned.
- c. Times the preferred dividend requirements were earned.

2. A large manufacturing corporation finds that it requires \$2,000,000 of additional working capital for about three months of every year. Since the success of the company's operations depends upon the availability of this seasonal working capital, stock is issued for this purpose. The management is also concerned with the investment of two reserve funds, each totaling over a million dollars. The first is an insurance reserve fund carried on certain scattered assets of the company. The second is a pension reserve fund which has been accumulated as a result of a voluntary pension plan established by the corporation. Suggest the general principles which should govern the investment of these funds and the types of securities which may properly be used.

3. Upon reference to the latest annual reports published by each of the following companies, determine the respective proportions of total earnings derived from (a) direct operations and (b) other sources. Comment in each case upon the relationship exist-

ing between the business in which each company is engaged and the nature of other income:

1. Union Pacific Railroad Company
2. General Electric Company
3. F. W. Woolworth Company
4. E. I. duPont deNemours Company

CHAPTER XVII

Business and Banks

The Relationship of Business and Banks

No business of any size can get along without entering into some banking relationships. The first thing a man entering business should do is to establish friendly contact with some commercial bank. The importance of making such a connection cannot be overestimated, for banks fill a very necessary place in modern business affairs. We have seen how the business man is often able to rely on banks for part of the working capital needed by his business. This is only one of the many services performed by the bank for its customers. Others will be detailed in succeeding paragraphs. The banks receive compensation for most of the services thus rendered through having the use of part of the money their customers have on deposit.

The relationship of a business with its bank is of necessity an intimate one. Where the bank is asked to lend funds to a business, it is entitled to absolute frankness on the part of the business man. The bank must always protect the liquidity of its loans, for it must be prepared at all times to meet the demands of its depositors, who may desire to draw out their funds. This attitude of frankness and willingness to disclose information required by the banker should persist from the business man's first introduction to his bank throughout all future dealings. As the various services performed by banks for the business man are discussed in this chapter, we shall endeavor to make clear the type of information about its customers which the bank requires.

Services Rendered Business by Commercial Banks

The list of services which may be performed by commercial banks for their customers is a long one. Many business men

are not acquainted with the facilities for various valuable services which are placed at their disposal when they establish banking relationships and maintain a good balance with a commercial bank. Needless to say, all of these services cannot be listed here, but business men should be familiar at least with the following:

1. As a depository and safe-keeper of his money.
2. As a collection and discount agency.
3. As a source of short-term loans.
4. As an agency for the transfer of domestic and foreign funds.
5. As a trustee.
6. As a source of credit information.
7. As an aid in the conduct of foreign trade.
8. As an expert financial consultant and adviser.

1. The bank as a depository and safe-keeper of money.—The bank is a convenient place to deposit cash for safe-keeping. A business man deposits his cash regularly, and the bank places each deposit to the credit of his account. If the depositor wishes to transfer any portion of his cash on deposit to a creditor, he simply draws a check payable to the creditor which can be used by him as the payee. A deposit may be placed in the bank either as a *special* or a *general deposit*. A *special deposit* is one consisting of money or valuables of any kind, for which the bank acts merely in the capacity of a warehouse: to care for and protect the deposit, and to return it to the depositor upon demand. The depositor always retains his title to the special deposit and can demand the return of the identical items deposited. The bank is in no sense the owner of the special deposit; it is merely its trustee. The banks usually maintain on their premises safe deposit vaults and for a small rental, make available safe deposit boxes to their customers, thus obviating the cumbersome handling of special deposits. The *general deposit*, consisting usually of cash, checks, notes, drafts, and coupons, is turned over to the actual ownership of the bank, which becomes a debtor to the depositor. In the transaction, the latter becomes a creditor of the bank: he has a claim against it to the amount of the deposit and has the

right to demand the payment of all or any part of it. These general deposits may be made payable on demand (*demand deposits*) or after a specified time (*time deposits*). Business men's accounts are mostly on a demand basis.

2. **The bank as a collection and discount agency.**—The business man uses the credit he has established through his deposits as a means of paying his bills by check. A *check* represents the depositor's order on his bank to pay a certain sum to a third party. The bank, in the usual course of business, will pay the check upon presentation by the payee or his endorsee, and will charge the amount against the depositor's account. Payment by check is general in the United States. It is estimated that at least 80 per cent of the business transacted outside of New York City is paid by check and in New York City, 90 per cent.¹

The depositor's bank presents the checks drawn on other banks and arranges the method of remittance. This service is known as "collection." The bank merely serves as agent for its depositors in collecting checks drawn on other banks but deposited with it. It is one thing to collect a check and quite another thing to make the funds available to the depositor. Suppose that a merchant in San Francisco buys merchandise in New York and remits by a check drawn on his local bank in San Francisco. The New York manufacturer will deposit the check in his bank, which, in turn, will return it for collection. Not until the check is actually presented to the drawee bank, charged against the account of the maker, cancelled, and the settlement made with the presenting bank is the collection process complete. The agent now has the funds. The process of getting the funds back to the New York bank is the "exchange" function.²

Business men occasionally accept *promissory notes* from their customers in settlement of accounts. If the business is in need of funds, such notes may be endorsed and discounted with the bank, and the business man receives either credit on the books of the bank or cash for the face value of the note less the discount. At maturity, if the bank has not rediscounted the note with some other bank, it will

¹ Jones, *Clearings and Collections*, pp. 13; 255-6. ² *Ibid.*, pp. 19; 175-6.

proceed to collect it from the maker. Only when the maker does not honor the note will the business man hear of it again, for in such a case he is liable as an endorser. Should the business man not be in need of cash, he may hold the note until maturity before presenting it to his bank for collection. The bank then acts as his agent in collecting it. Often this service is rendered without charge, especially if the note is to be collected from someone in the vicinity. If, however, the maker lives out of town, a charge will usually be made for collection.

Occasionally a seller of goods will draw a *draft* for the proceeds. A *draft* is an unconditional order in writing—addressed by one person (drawer) to another (drawee) and signed by the drawer—which requires the drawee to whom it is addressed to pay on demand, or at a fixed or determinable future time, a certain sum of money to, or to the order of, a specified person, or to the bearer (payee).³ The draft may be payable on demand. In that case it is called a *demand* or *sight draft*. Should it be payable at some future time, it is called a *time draft*. When a time draft based on a commercial transaction is sent by the seller (drawer) to the buyer (drawee) for acceptance and the drawee accepts it by writing on the face of the draft *accepted*, affixing his signature and designating the place of payment; the instrument is called a *trade acceptance*. The accepting of a draft means that the drawee—now called the acceptor—has acknowledged on its face that he will pay the draft at maturity.

Sight drafts are ordinarily used in an attempt to enforce the collection of overdue accounts and are not discounted by banks; the banks act merely as agents for collection, and often charge for the service.

Time drafts and trade acceptances are often discounted by a bank for its customers. The bank advances the face value less the discount, figured at current interest rates to maturity. The bank may either hold the draft until maturity and then present it for payment, or it may rediscount it with another banking institution, probably the Federal Reserve Bank.

³ Adapted from the English Bill of Exchange Act.

Drafts are also useful as a means of making C. O. D. shipments. Bills of lading are drawn in negotiable form to order, and a draft for the value of the shipment is attached. The business man's bank will forward both documents to a bank in the buyer's locality. Since the carrier will deliver the goods only upon presentation of the bill of lading, the buyer must obtain the bill of lading from the bank by payment of the draft. Occasionally, the terms will provide for the delivery of the shipping documents upon acceptance of the draft for payment at some future date.

Bank acceptances.—A draft drawn upon a bank and accepted by it is known as a *bank acceptance*. Suppose that a New York merchant wishes to buy a carload of oranges from a Los Angeles dealer. The Los Angeles dealer does not feel that he is sufficiently well acquainted with the New York merchant to extend credit on *open book account* or to agree to allow the buyer to accept a 90 day draft. There is no prospect of raising sufficient cash to pay the bills. In such a case, the New York buyer may make use of a bank acceptance.

In making such an arrangement the services of both the buyer's bank in New York and its Los Angeles correspondent may be required. The following summary indicates the steps to be taken:

1. The buyer makes application to his bank to authorize the issuance of a *commercial letter of credit* (commonly termed *commercial credit*) by a Los Angeles bank in favor of the seller. The terms of the authorization allow the Los Angeles bank to accept drafts drawn upon it by the seller and promise that the New York bank will place the Los Angeles bank in funds to pay the draft at maturity.

2. The New York buyer signs an acceptance agreement whereby he agrees to put the New York bank in funds to pay the acceptance at or before maturity.

3. The New York bank forwards the authorization to the Los Angeles bank.

4. The seller ships the oranges and draws a draft against the Los Angeles bank, attaching bills of lading and any other documents specified in the terms of the credit.

5. The Los Angeles bank accepts the draft on presentation by the seller (drawer).

6. The drawer discounts (or sells) the acceptance at an interest rate lower than the rate at which he could borrow, since the greater the financial strength of the acceptor the lower the rate.

7. The Los Angeles bank honors this acceptance on due date.

8. Before maturity the buyer pays the New York bank the amount of the draft; and the New York bank places the funds to the credit of the Los Angeles bank, which now pays the acceptance at maturity.

The use of bankers' acceptances in domestic trade is usually associated with the carrying of raw products, such as cotton, in transit or in storage. In the former case a bill of lading is attached, and in the latter a warehouse receipt. Bank acceptances are more frequently used in the financing of foreign trade.

Banks make a small charge for accepting, usually one-fourth of one per cent for a 90 day draft; this sum is equivalent to an annual rate of one per cent.

3. **The bank as a source of short-term loans.**—Of all the functions performed by the commercial bank, the most important is that of supplying the needs of business for short-term capital in the form of *bank loans*. Banks derive the greater portion of their earnings from interest charged on loans. From the standpoint of business in general, the lending function is an extremely useful one. Through the medium of the deposits of those who are not in immediate need of funds, a bank obtains the basis for extending credit to those who do need them. It is to be noticed, also, in this connection that many businesses have seasonal needs for additional capital which can be properly supplied by bank loans; whereas, it would be uneconomical to use long-term loans or owned capital for the purpose, as it would not be in use all the year round.

We have seen how a business may obtain cash or bank credit through the discounting of various types of *customer paper* at the bank. In order to borrow at the bank, a busi-

ness discounts its own promissory note. This procedure includes the usual discount operation: the bank discounts the note when it is presented; that is, the interest is deducted to maturity, and the account of the borrower is credited only with the net proceeds. If, however, the loan is a *demand loan* (as most loans against collateral security are likely to be), the borrower's account is credited immediately with the face value of the note, and interest is charged against the account on a monthly basis.

Borrowing from a bank either when the business possesses good credit or when it can offer acceptable collateral as security should be a simple operation. Borrowing, when obligations are promptly met, enhances the credit of a business and makes the account of such a business a very desirable one from the viewpoint of the bank. A business which preserves a clear borrowing record and which is in the habit of making use of bank loans often finds that it is in a far better position to obtain bank loans in times of stress than is the business which looks upon the bank only as an emergency reservoir of funds to be tapped when times are hard, inventories frozen, and the business itself stormed for cash.

Bank loans ordinarily cost from 6 to 8 per cent, according to the minimum deposit requirements of the bank. As will be shown later in this chapter, banks often require that a borrower on an unsecured note must keep a certain percentage of the loan on deposit. Since the member banks of the Federal Reserve System are prohibited by law (Banking Act of 1933) from paying interest on demand deposits, the cost of the loan is increased by this requirement, for, to the cost of the funds actually used in the business, must be added the cost of the amount tied up in the bank and not earning any return.

Unsecured loans.—It has been variously estimated that from 60 to 70 per cent of bank loans are *unsecured*: no collateral is deposited with the banks; and such loans are made with no other security than the general credit of the borrower, which is pledged when the promissory note is signed. Banks have learned through long experience that unsecured loans may be made safely where proper care is exercised in investigating the credit standing of the borrower. "Good

banking is not pawnbroking or collateral lending but is the recognition or cashing of current titles based upon values growing out of ordinary trade and unaccompanied by detailed or particular evidence of ownership of goods.”⁴ Since business in the United States is largely conducted on the *open book account method*, it would be almost impossible for the average business to obtain loan accommodations at banks on anything but an unsecured basis. Open book transactions do not give rise to negotiable paper which could be used for collateral, and the goods themselves have passed from the possession of the seller. Then, too, the practice of selling goods on open book account often makes it necessary for the seller to borrow to finance his accounts receivable.

Establishing credit at the bank.—Before a bank will lend on an unsecured note, the borrower must establish his credit. The bank must be assured that the loan will be paid when due. Great emphasis is placed on the character of the management. In addition, depending upon the circumstances, the bank may conduct careful investigations and require considerable information as to the borrower’s credit standing. Banks may use any, or all, of the following means of obtaining information as to the advisability of granting a loan:

1. Personal interviews of the borrower by the bank officers.
2. Financial statements of the business with supporting schedules explaining items appearing on these statements. Statements covering a period of two or three years are desirable so that trends may be noted.
3. Reports of commercial agencies: those of general scope offering reports on all businesses everywhere, and those specializing on concerns in a particular line of business.
4. Statements from other banks in which the borrower carries, or has carried, accounts, or with which he has had other business dealings.
5. General data from other concerns in the same line of business.
6. Records of the bank itself, since the borrower is usually a regular customer of the bank from which he seeks to borrow.

When making application for a loan, it is quite usual for

⁴ Willis, H. P., and Edwards, G. W., *Banking and Business*, p. 117.

a business to be called upon to furnish considerable information as to its financial standing. Income, profit and loss statements, and balance sheets, not only for the present but also for previous periods, are usually requested by the bank. Supporting schedules of information are often required if the figures shown by the statements are not self-explanatory. Frequently the bank will supply forms to be filled out by the business man. While forms vary for different banks, supplementary information is usually required regarding officers and directors, reserve and depreciation policies, bad debt losses, inventory valuation, contingent liabilities, real estate owned, auditing and trade discount practices.

In recent years it has become a more and more common practice for banks not only to require figures on past operations but to insist that the business furnish a budget showing the expected receipts and disbursements for the ensuing period and often, also, an estimated statement of its income profit and loss.

By such procedure, the bank is able to see when the loan can be repaid and whether the expectations of the business man are reasonable. The banker also knows that in making up such a budget, the business man has had to plan in advance all the details of his operations, and thus the chance of mistakes through hasty judgment is largely eliminated.

The line of credit.—With all the information concerning the borrower in hand, the bank will complete its investigation and determine how much the customer may borrow and for how long a time. The maximum amount which may be borrowed is known as the *line of credit*.

The customer is supposed to borrow from time to time against this credit in the amounts necessary to see him through his successive needs. The sum of all the loans that he has outstanding at one time will not be allowed, of course, to exceed his line of credit. It sometimes happens that a firm may obtain from the bank a line of credit and apply for one loan to cover the entire amount, but this practice is unusual. As long as the business pays up its various loans promptly and occasionally cleans them all up, and observes the various rules and standards of the bank, the line of credit remains open and the bank does not make a new investigation of each application. Periodically, however, the bank

will institute an investigation to ascertain whether the business at its present size, is still in condition to justify the line of credit, or whether it should be cut down. Of course, applications to increase the line of credit will always lead to re-investigation.

It is quite common for businesses to arrange for concurrent lines of credit with several banks. Such a practice will, generally, if the firm is sound and prosperous, expand or increase the credit standing of the business and make it somewhat independent of any one particular bank. It is understood, of course, that the business does not have at each bank a line equal to its total credit standing, but that each bank is cognizant of the customer's line at the other banks and extends to him a line which, when combined with the lines at the other banks, will not exceed his rating.

It is customary for banks to require an annual *clean-up* of customers' loans, and many businesses make this clean-up at one bank with funds borrowed from another. Where there are several lines of credit with different banks, a sort of *revolving credit* is thus set up. Good business demands that this be done only with the knowledge and, at least the tacit, consent of all concerned. Smaller businesses, however, and those whose credit is not particularly strong, will find it better policy to devote all of their efforts to strengthening their credit and building up a satisfactory line with one banking house.

When a line of credit is once obtained, it must be *kept open*, and this can be done only by the borrower's observing all the rules and requirements of the bank. Various institutions have different minor regulations, but the principal ones usually found are:

1. That the customer must maintain a deposit equal to a specified percentage of the line of credit. The percentage usually required is 20, though in some cases it may be 25 and occasionally it may be set as low as 10. The business man should realize that maintaining a substantial deposit is one of the very surest ways of retaining the confidence of his banker.

2. That the customer must clean up all loans periodically.

usually once a year. By insisting on this annual clean-up of loans, the bank makes certain that it is lending only to prosperous concerns and for temporary working capital. Only in exceptional cases and for good reasons should a bank countenance a customer's cleaning up his loans by the use of funds borrowed for the purpose from another bank at which he has established a line of credit.

Once a line of credit is granted, the borrower may expect the bank to watch the manner in which it is used. The bank may require additional financial statements from time to time and occasional interviews with the borrower. The bank is also usually cognizant of the business deals of its customers, and its officers are often able to observe without formal investigating whether money lent is being properly used. Should the bank become doubtful of practices followed by the borrower, it probably would call for an explanation; and should the explanation be unsatisfactory, the line of credit may be curtailed or canceled entirely.

Secured loans.—Some loans are made only against collateral security of some kind. These loans are usually termed *collateral loans*. Banks require this sort of security when the risk is such that it would not be prudent to lend on an unsecured basis. In some businesses it is practically always necessary to offer collateral as a basis for obtaining loans. For example, practically all loans to stock brokers for the purpose of financing customers' margin accounts are handled in this way; stocks and bonds are pledged as collateral.

Banks greatly prefer collateral which is readily marketable, because that feature adds to the liquidity of the loan. Where possible, a variety of collateral is more acceptable than all of one kind, for, obviously, there is likely to be greater safety where this principle of diversification can be followed. Banks reserve the right to sell the collateral in case of default; and the loan is made due and payable at once if the collateral depreciates in value, unless additional collateral is deposited. These requirements will be made clear by a study of the following typical collateral loan agreement.

Typical Collateral Loan Agreement

..... Dollars 19....

ON DEMAND, for value received, promise to pay to THE NATIONAL BANK of of order, at its banking house Dollars with interest at the rate of per centum per annum, having deposited with said Bank, as Collateral security for payment of this or any other direct or indirect liability to said Bank, due or to become due, or that may hereafter be contracted

In case of depreciation in the market value of the security hereby pledged, or which may hereafter be pledged for this loan agree to furnish, on demand, satisfactory additional security, so that the market value thereof shall always be at least per cent more than the amount of this note. And failing to deposit such additional security, this note shall be deemed to be due and payable forthwith, anything hereinbefore expressed to the contrary notwithstanding and the said Bank, or its assigns, may immediately reimburse itself by the sale of the security, as hereinafter authorized. And authority is hereby given to the said Bank, or its assigns, to sell, assign and deliver the whole or any part of the said Collateral, also any security substituted therefore or added thereto, without notice or advertisement, either at public or private sale, at the option of the said Bank, or its assigns, on the non-performance of this promise; any balance of the net proceeds of such sale remaining after paying all sums, whether then or thereafter payable, due from to the said Bank on account of this note or otherwise, to be returned to And it is further agreed that the said Bank, or its assigns may bid and become purchasers of such sale, and no other purchaser shall be responsible for the application of the purchase money.

(Signature)

Collateral for loans.—There are scores of items that may be used as collateral; but the principal ones only are mentioned here, and they may be set forth as follows:

- A. Financial type.
 1. *Stocks.*—Certificates of stock in business organizations are acceptable collateral if they are marketable and may reasonably be expected to remain so till the expiration of the time of the loan.
 2. *Bonds.*—Corporate, municipal, or government bonds are acceptable if they are sound and marketable.

B. Merchandise type.

1. *Warehouse documents*.—A *warehouse receipt* is a receipt for goods stored in a warehouse. The warehouse company acknowledges receipt of the goods and agrees to their safe custody and re-delivery upon surrender of the receipt properly indorsed and payment of the charges. It constitutes a document of title to the owner or to the holder to whom the goods are deliverable. These receipts are issued in both negotiable and non-negotiable form (usually the former), so that they may be used as collateral for bank loans.
2. *Transit documents*.—The *bill of lading* is the principal transit document. It is a receipt issued by a carrier certifying that he has received the therein-described goods from the within-named consignor for transportation to a certain destination, to a specified consignee, or to the order of any person. It serves as a receipt for the goods, a contract to transport, and a document of title. There are *straight bills of lading* and *order bills of lading*. The *straight bill of lading* states that the goods are consigned or destined to a specified consignee, and is intended primarily for domestic shipments; while the *order bill of lading* consigns the goods to the order of any person, and is intended for both domestic and foreign shipments. A straight bill of lading must be marked "Non-Negotiable," and duplicates must be characterized. Title to the goods rests with the consignee; while he may transfer his title by indorsement and delivery, he can transfer no better title than he holds, and a bank that lends on a straight bill of lading to a wrongful person has no protection. An order bill of lading, however, may be negotiated; and, when it is properly indorsed, any holder in good faith has title to the goods. This document, therefore, is good bank collateral.

3. *Trust receipts*.—With a bank in possession of a warehouse receipt, bill of lading, or other such document, it is impossible for the merchant to get possession of his goods so as to dispose of them and pay off the loan. The bank will, therefore, often release the document held as collateral if the borrower signs a *trust receipt*, whereby the bank obtains the title to the goods and the borrower pledges to turn over to the bank the first proceeds from the sale up to the amount of the loan. The legal status of the trust receipt is not well established, and it is not considered first-rate collateral, particularly where the goods released in trust cannot be adequately earmarked.

C. Personal type.

1. *Real estate*.—Deeds, deeds of trust, mortgages, leases, and similar rights in good real estate may constitute good bank loan collateral, though, as a rule, commercial banks do not favor this type.
2. *Chattels*.—Deeds, deeds of trust, bills of sale, and similar rights in movable goods capable of transfer—such as, portable machinery, furniture, live stock, crops, and many similar things—may constitute acceptable collateral. Many banks, however, decline to accept them as such on the ground that they may lack marketability.
3. *Bank books*.—Savings bank pass books, which serve as vouchers or receipts for deposits made, and without the presentation of which withdrawals cannot be made, are often assigned to a bank as collateral for a loan. Some savings banks, however, prohibit the assignment of their pass books.

Bank requirements as to collateral.

A. *Margin*: Banks will demand that the market value of the collateral exceed the amount of the loan so as to safeguard the bank in case of possible shrinkage of the value of the collateral. The excess margin usually required is about

20 per cent; and when, through a decrease in the value of the collateral, it falls below this percentage, the borrower may be required to deposit additional collateral.

B. Character of collateral: Banks will not depend entirely on a margin for their protection; they will also insist that the collateral be of a satisfactory character. On a large loan they will demand *mixed collateral*, consisting probably of railroad, industrial, and other securities, rather than *straight collateral*, consisting of securities of only one class. Likewise, they will not grant too many small loans, each secured by the same type of collateral. Where corporate securities are used, they should be conservative, rather than speculative, issues; they should be active on the market, rather than inactive; and they should have good delivery—that is, they should be negotiable in form and indorsed in blank by the borrower. Property other than securities is not acceptable as collateral, unless it has a determinable value and a potential market.

Commercial banks should not be expected to furnish long-term capital.—Not only is it bad banking for the commercial bank to furnish loans for investment in the fixed assets of a business, but it is also a dangerous practice for the business. Bank loans should be self-liquidating; that is, the assets in which they are invested should be regularly converted into cash in the usual course of business so that the loans may be repaid when due. If a business places funds derived from bank loans into fixed assets, there is always danger that cash will not be available to repay the loan when due. Then, if the bank refuses to renew, the business may face serious financial difficulties, perhaps bankruptcy.

The same danger may result if bank loans are used to speculate in inventories. Large inventories may be slow to liquidate and hence become almost the same as fixed assets. If bank loans invested in this manner come due, it may be necessary to reduce the inventory through sales at cut prices; this practice involves severe losses.

4. The bank as an agency for the transfer of domestic and foreign funds.—Practically all commercial banks have correspondent banks in other cities in the United States and

will sell drafts on their correspondent bank which may be used in remitting funds. A bank draft has better acceptability than a personal check or the check of a small corporation, and may be more desirable for that reason. A merchant in Chicago may wish to pay a debt to a New York firm in New York funds. This may easily be accomplished through the aid of a Chicago bank which maintains a balance in some New York bank. The Chicago bank will sell a draft on the New York bank which may be used for the remittance. Banks also remit funds by telegraph for their customers to different cities.

The larger banks in New York and a few other large financial centers have foreign correspondents and are able to render the same services in connection with the transfer of funds internationally as are described in the preceding paragraph with respect to domestic payments. This does not mean that the small banks or banks without international connections cannot assist business in this way. The smaller banks invariably have balances in larger banks and through these connections are able to render practically the same service.

5. The bank as a trustee.—Many commercial banks have trust departments. A bank acting as a trustee may care for various funds, including such a fund as an employees' pension fund, which the business management may not wish to care for itself. Through its corporate trust department, the bank will act as a trustee for mortgage bond issues, as a depository for stocks and bonds held under trust agreements, and often as a registrar or transfer agent for the corporation's securities. The latter service, however, is not a trust function but is more in the nature of a fiscal agency service, although it is usually handled by the corporate trust department.

6. The bank as a source of credit information.—Banks, of course, are not credit agencies. They do, however, maintain files of credit information; in fact, large banks maintain separate credit departments. The information collected serves the bank's own purposes in its dealings with those businesses with whom the bank may have relations, and

usually the bank will give credit information upon inquiry by its depositors. Large city banks with foreign connections are frequently the only easily available sources of information on the credit standing of foreign houses. Banks are often named as references by their customers who are seeking credit accommodations elsewhere, and will usually give information as to their customers' credit standing. The confidential relationship existing between the bank and its depositors is, however, seldom violated, as the information given is usually general and such as not to violate any trust reposed in the bank.

7. The bank as an aid in the conduct of foreign trade.—Almost all foreign trade transactions require the services of a bank. The bank forwards and collects drafts drawn against the consignee and delivers the bills of lading upon payment or acceptance of the draft. An importer may arrange for a letter of credit with a bank and instruct the bank to make payment against it upon presentation by the exporter of the shipping documents evidencing shipment of the specified goods. A shipper of goods to far-off lands may obtain funds immediately by drawing a draft against the buyer and, after attaching the bill of lading and other shipping documents, by discounting the draft with his banker. The bank will then proceed to collect the draft through its foreign correspondent. Banks also sell drafts and cable transfers in foreign exchange so that remittances may be made in the currency of the country to which the payment is to be sent. Interior banks which are not equipped to give full service in connection with foreign trade may usually do so with the assistance of their connection with large banks which have foreign departments.⁵

8. The bank as an expert financial consultant and adviser.—No business man should overlook the splendid assistance which may often be rendered by his banker in the way of timely financial advice. The confidential relationship of the banker to his many customers gives him a very thorough insight into business affairs in general. The

⁵ A discussion which would fully cover the various services performed by banks in connection with foreign trade is beyond the province of this text.

banker sees the errors made by business men who are his customers. He sees the results of these errors and may use this knowledge to prevent others from making the same mistakes. He is financially trained and is often able to guide a business man into more prudent financial practice through giving him the benefit of his wide financial experience. It is not to be implied that the banker is infallible—that he does not err as do other humans. His advice is, however, always worth seeking, and a discussion of business plans with the banker is always advisable, since he may not only save losses but may also contribute some valuable profit-making ideas.

The Attitude of the Business Man Toward His Bank

In the foregoing discussion an effort has been made to touch upon some of the many services a business man may expect to find its banker willing and able to perform. The business man who keeps his character above reproach and his credit good, and who shows reasonable capacity and aptitude in his business, need have no fear that the banker will not be glad to do business with him. Bankers are interested in helping their customers to success if they can do so with no more than a normal risk. They are as anxious to sell the services of the bank as a merchant is to sell his goods. They must, of course, be careful to maintain their own integrity, through sound judgment in making loans. Banks are, in a sense, trustees of their own credit, which has been pledged to the community; and care in the exercise of their banking functions is more than a mere phase of the dealings with their customers. It is a community trust.

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Questions for Study and Review

1. State eight services performed by the commercial banks.
2. Discuss the functions performed by the bank as a collection or discount agency.

3. What is meant by a draft, a sight draft, a time draft, a trade acceptance?
4. Distinguish between a trade acceptance and a bank acceptance.
5. What is an unsecured loan; a secured or collateral loan?
6. State six sources of information available to the bank seeking credit information for the purpose of granting a loan.
7. What is meant by a line of credit? State two rules usually enforced by the bank if the line of credit is to be kept open.
8. Name the various kinds of collateral acceptable as security for bank loans, classifying them as financial type, merchandise type, personal type.
9. What are the usual bank requirements as to collateral?
10. *a.* Discuss the service performed by the bank in transferring funds.
b. Discuss the functions of the bank as a trustee.

Problems

1. Mr. Adams, a young man engaged in a small manufacturing business which he owns outright, finds that he can use additional funds in his business for a few months. He wishes to arrange a line of credit at his bank; and, since this will be his first application for a bank loan, he is particularly anxious to make a good impression on his banker. Advise him regarding the type of information he may be expected to provide.
2. A New York importer purchased goods from a German firm. The German exporter drew a sight draft, with bills of lading attached, which is now in the hands of a New York bank. Explain how the importer may arrange with his bank to finance this shipment until the goods have been sold and payment for them received.
3. The Willis Furniture Company, Inc., on April 1, 1925, bought a bill of furniture from the Famous Furniture Factory to the amount of \$6,795, and agreed to settle by means of a trade acceptance due in 90 days. Draw up the instrument in complete

form with the acceptance indorsement. In a brief statement, tell how the financial transaction is completed.

4. The Ara Cotton Company, manufacturers of cotton goods, find themselves in need of about \$50,000 to carry them until the end of the selling season. The bank has already lent as much as it feels that it should. However, the banker desires to be of help and advises other means of financing. What means might he suggest?

ARA COTTON COMPANY, INC.

Manufacturers of Cotton Goods

April 13, 1932

ASSETS:

Inventories of Stocks.....		\$1,187,872.94	
Cash on Hand and in Banks.....		89,638.96	
Notes Receivable.....		350.00	
Accounts Receivable.....	\$ 501,490.22		
Less Accrued Discounts.....	16,103.48	485,386.74	
Total Quick Assets.....		\$1,763,248.64	
Real Estate, Buildings, Machinery.....	\$1,119,659.22		
Less Reserve for Depreciation.....	430,691.94	688,967.28	
		<u>\$2,452,215.92</u>	

LIABILITIES:

Notes Payable (Bank Loans).....		\$ 790,000.00	
Accounts Payable.....	\$ 76,795.60		
Accrued Payroll.....	8,662.50	85,458.10	
Floating Debts.....		\$ 875,458.10	
Surplus Account.....		1,276,757.82	
Capital Stock.....		300,000.00	
		<u>\$2,452,215.92</u>	

(Signed) The Ara Cotton Company, Inc.
J. B. Ara, Treasurer.

Bank Accounts: The AB National Bank, New York City.
The DC National Bank, New York City.

Above figures prepared by X and W, Certified Public Accountants.

Analyze the statement in detail and tell whether you, as a note-broker or a banker, would purchase commercial paper if it were offered.

5. A New York manufacturer has secured an order from Buenos Aires. His foreign customer desires 90 days credit, which the New York manufacturer does not wish to grant. How may the transaction be handled so as to give the desired extension of time without requiring the assumption of credit risk by the New York shipper?

CHAPTER XVIII

Credit and Collections

The importance of credit.—Modern business could hardly exist without the extensive use of *credit*. Goods are bought on credit and sold on credit. Various credit instruments such as checks, notes, and drafts are in daily use. Corporations borrow large sums of money both for long and short terms. In fact the paper currency we use is merely the promise to pay of a Federal Reserve bank or of the Federal Government.

The use of credit makes possible a more productive employment of capital. Those who have funds which are idle may lend them to another who can employ them productively. Thus, the lender profits from their use, for he receives interest on the money lent; and the borrower receives a benefit from them as he seeks to use the funds profitably in his own business.

The demand for, and the constant use of, credit makes it a very desirable thing to possess. Consequently, there is an incentive for the building up of those things upon which credit depends; namely, a reputation for good character, for capacity in managing business and personal affairs, and finally for the amassing of capital through diligence and thrift.

Without credit almost every business transaction would require an immediate exchange of values. In most cases, money would be demanded, with the result that a tremendous volume of gold or other standard of value would be required. Indeed, it is practically impossible to imagine conducting all of the country's business on such a basis.

Classes of credit.—In the conduct of the vast business affairs of the world, credit assumes various types or forms, which may be classified as follows:

1. *Public credit*: credit of a government—national, state,

municipal, etc.—usually looked upon as its borrowing power, or expressed as its reputation and ability to pay its obligations.

2. *Bank credit*: deposits, loans and discounts.

3. *Investment credit*: credit used by a business for its fixed assets or regular working capital and represented by real estate mortgages, corporate bonds, long-term notes, etc.

4. *Personal credit*: credit accepted by a merchant from an individual or family to enable them to procure, on a time-payment basis, goods for their use or consumption; or, any credit offered by an individual for personal rather than business use.

5. *Mercantile credit*: credit passing between one merchant and another, when goods or materials are bought for resale or are to be used in manufacturing other articles for sale.

6. *Agricultural credit*: credit accepted by various creditors from farmers to aid in the production, marketing, and movement of crops; formerly considered as a mixture of mercantile and personal credit; now considered by a number of economists as a separate and distinct class.

Of these classes of credit, the first mentioned, public credit, is outside the scope of our subject. Personal and agricultural credit are likewise subjects which, although of great importance to business, form separate subjects of study in themselves. Stocks, bonds, notes, and securities in general, constituting investment credit, have been studied in several of the preceding chapters. It is of bank and mercantile credit that we wish to treat in this chapter, because these two classes of credit are the ones which businesses use to provide a portion of their working capital. The purposes of these two classes of credit are similar: bank and mercantile creditors extend short-term credit and use the same sources of credit information. Wherein they are unlike is set forth on pages 354-355.

Giving and receiving credit.—When a business purchases goods *on time*, it offers or *gives* its credit to the seller, who accepts it. When the business, in turn, sells the goods to its own customers on time, it *accepts* or *receives* the credit of its customers. The credit policy of a business, therefore,

extends in two directions. It is concerned with the purchase of goods and with their resale. It is wise to appreciate the importance of a well-considered credit policy in any business, for, useful as credit may be in the conduct of the business it concerns, often a business gets into difficulty because of misuses of its credit.

The credit department.—The *credit department* of a business is concerned only with the credit of sales. The credit of its purchases is under the control of its purchasing department and its treasurer. The former makes the contracts, and the latter must protect the credit reputation of his concern by prompt payment of credit obligations. Since this latter function depends to a large extent upon the wise extension of credit and the prompt collection of receivables by the credit department, it will be seen that there is a close analogy between the policies of credit purchases and credit sales. Both necessarily are under the control of the financial management of the business.

While every business does not have a separate department devoted to the extension of credits and collections, except for the comparatively few concerns which do a cash business exclusively, someone must function as a credit man. An efficient credit man, while he may perform other tasks, is therefore as essential to the small business as to the large.

This chapter deals with the subject of credit in a general way. The work of the credit department is specialized and forms in itself a separate study.

The credit manager.—A *credit manager's* duties include much more than simply preventing losses on customers' accounts. If that were the only objective, it could easily be attained by selling only to customers whose credit standing was A 1. However, if the concern were to sell only to this class of customers, it is likely that it would find its business very small indeed. Some risk must always be taken, and it is the credit man's duty to see that unwarranted risks are not taken. In short, the function of the credit man is to have a "minimum of losses with a maximum of sales."

The credit man should be sales-minded. His attitude should always be to try to find a way in which credit can be safely granted and the sale made. Often this requires

that the problems of the business asking for credit be studied and helpful advice given to the customer so that he will become a reasonably safe credit risk.

Not only must the credit man be diplomatic in dealing with the firm's customers so as to keep their goodwill, but he must especially cooperate with and gain the goodwill of the sales manager and the salesmen. The salesman comes in contact with the customer and can supply the credit man with much useful information, provided he has not been antagonized. The sales manager and the salesmen should be made to realize that the credit manager is as anxious to make sales as the sales department and that, when orders are turned down because of lack of credit standing, everything possible has been done to find a way in which the sales could have been safely made.

The work of the credit manager is interesting and is professional in character. It requires not only a training in the analysis of financial statements, but a broad training in economics, accounting, commercial law, and general business practice.

Analyzing the credit risk.—It is impossible in this text to more than touch upon the principles underlying the analysis of a *credit risk*. There are four primary factors which must be considered in the analysis of any credit risk. These factors are: (1) the character of the debtor, (2) the capacity of the debtor or the management of the debtor business, (3) the capital investment in the debtor business, and (4) the economic conditions of the industry. In an analysis of these factors the creditor is interested in one question, Will the debtor pay?

Character is an essential element of any credit risk. If the character of the applicant be poor, the credit man seldom proceeds further. The character of the management of a concern is known by reputation, and is ascertained through information received directly or indirectly from those who have had dealings with it. Honesty and intention to pay must exist; otherwise, there would be no object in going into the question of ability to pay.

From the credit man's point of view, *capacity* means ability to manage the business for which credit has been asked;

it extends to all the factors which may make for the failure or the success of the business itself. For instance, in addition to investigating the ability of the management, the credit man would be interested in knowing whether or not the business is favorably located and whether its methods are up to date.

The *capital or financial strength* of the credit risk comes in for very careful investigation. It includes a knowledge of the amount of capital invested, borrowed, and owned; the portion invested in fixed assets; and the amount already in current assets. It is indicative of the resources available for the settlement of any claims against the business.

Economic conditions affect the credit risk and always have a bearing on the problem. In particular, the manner in which current economic conditions affect the industry of which the business is a part may indicate probable trends in the future of the concern whose credit is being analyzed. It should also be borne in mind that conditions such as rapidly falling price levels, extreme booms, labor troubles and similar fundamental factors, are points which the credit man must not overlook in passing upon the risk.

Sources of credit information.—The more common sources of information may be classified as follows:

I. From internal sources:

- a. Debtor's previous credit record with the house.
- b. Credit man's personal knowledge of debtor's reputation.
- c. Personal contacts with debtor.
 1. Through correspondence.
 2. Through visits by credit man or his representative.
 3. Reports of salesmen.
- d. Analysis of debtor's financial statements.
- e. Audits or surveys of the business.

II. From external sources:

- a. Mercantile agencies.
- b. Trade references.
- c. Banks.

- d. Attorneys.
- e. Public records.
- f. Miscellaneous.

It is not to be inferred that all of these sources are, or should be, called upon in the analysis of every credit risk. Seldom is it necessary to make use of more than a few of them. Sufficient information is obtained, if possible, to show whether or not the risk is one which should be taken. Often, sufficiently complete information can be obtained from a mercantile agency, such as Dun and Bradstreet Co., if such service has been subscribed for. Trade associations also maintain interchange bureaus through which members exchange information. The extent of the credit investigation is largely determined by the size, importance, and profitability of the account and the chance of repeat orders. New accounts require more investigation than old, reliable customers. If the house deals only with high-grade risks, its credit department expense, including the cost of investigation, is naturally lower than that of houses with more liberal credit policies.

Financial statement analysis.—Applicants for mercantile credit, like applicants for bank loans, are often asked to supply financial statements and to furnish supplementary information regarding the management, auditing and valuation policies and trade practices as mentioned on page 333. Mercantile credit differs somewhat from bank credit, and due regard for these differences must be given to any statement analysis made for mercantile credit purposes. Some of the more important differences follow¹:

“1. The bank lends money either on a promissory note or on the security of satisfactory collateral. No collateral, however, is required in the case of the usual commercial loan. The seller who extends mercantile credit allows the buyer merely to have possession of the goods for a certain period of time before payment falls due.

“2. Bank credit is ordinarily given in order to enable the customer to *discount* his merchandise bills, and thus make unnecessary the use of long-time mercantile credit.

¹Lincoln, E. E., *Applied Business Finance*, p. 663. Reprinted by permission of McGraw-Hill Book Company.

"3. Bank credit, again, is customarily extended in order to enable the borrower to secure funds for general working capital purposes, without any necessary reference to a specific single transaction. Mercantile credit, on the contrary, is extended only in connection with the purchase of a definite bill of goods.

"4. The bank discount rate charged on loans is usually very much lower than the *cash discount*, which the buyer forfeits provided he does not pay cash for the goods which he purchases.

"5. In granting bank credit, the banker normally takes far greater precautions than are considered necessary by the merchant or manufacturer in selling a bill of goods to a customer.

"6. There is naturally a much more intimate relation existing between the borrower and his bank than is customarily found to exist between the selling house and its customers. The number of merchandise accounts is far greater, and their average size much smaller, than is the case with bank credit accounts.

"7. Finally, there is far more competition in the extension of mercantile credit than in the granting of bank credit. The number of organized sellers of goods is many times as great as the number of commercial banks; and as credit must be extended frequently in small amounts, it is obvious that more risk can properly be taken. Bank credit more largely involves the use of the money and credit of others than of the bank itself; whereas, in granting a mercantile credit, the risk falls primarily on the owner's capital."

It should be understood that financial statement analysis requires training and experience before conclusions can be drawn from figures alone. In fact, the credit man is seldom content to rely entirely upon financial statements; he works with much additional information.

Terms of sale.—The question of whether to permit a customer to buy on a credit basis is not the only factor involved in mercantile credit. An almost equally important matter is: How long a time shall be given to the customer in which to pay his bill? The time thus allowed may vary from immediate payment upon receipt of the goods to several months from the date of the invoice.

Where an extension of payment time may be given the purchaser, it is an almost universal practice to offer him a *cash discount*; that is, to permit him to deduct a certain percentage of the bill if he pays it considerably in advance of the time at which it is finally due. Ten days after the date of invoice is the most commonly used period during which to allow a cash discount.

The size and time limit of the cash discount, and the final due date of the bill, quoted together, constitute the *terms of sale*. Thus, the expression, "2% ten d. net 30 d."—or as it is sometimes written, "2/10, net 30"—means that the bill in full is to be paid in 30 days from the date of the invoice, but that, if the customer pays within 10 days from the date of the invoice, he may deduct 2 per cent from the face of the bill.

Terms of sale vary greatly among the various lines of industry; by custom and practice, however, they are quite regular and well established within each line. Thus, general groceries, imported cigars, small bolts and rivets, boxes, bottles, and crude drugs are a few of the many commodities which are almost always sold on terms of "1% ten days, net 30"; and domestic cigars, groceries (canned goods), certain types of drugs and medicines, on terms of "1% ten days, net 60." The terms "2% ten days, net 30," and "2% ten days, net 60," are the most widely used of all terms and cover a large part of the items in general trade. But there are many variants; for instance, carload lots of furniture are often sold at "5% 30 days, net 60"; spun silk at "6% ten days, net 30"; woolens and worsteds at "7% ten days, net 4 mos."; and scores of other arrangements are in daily use. The cash discounts should not be confused with the trade discount, which involves no time element and is used as a result of trade custom and to permit price adjustments among various classes of buyers. The trade discount is not a discount for cash, since the purchaser receives the discount whether he pays cash or buys on credit, and irrespective of the date of payment.

Often goods are sold *C.O.D.*, which means that they are to be paid for upon delivery, and a draft on the purchaser is generally attached to the bill of lading when the merchandise is shipped by freight. This is practically equivalent to a cash sale. In rare cases cash terms imply payment before the goods are shipped. These are known as *C.B.D.*, which means cash before delivery. The custom is, when the goods are sold on cash terms, to allow customers a reasonable period of time to inspect the goods before payment.

Sometimes bills are dated ahead; the cash discount privi-

lege is then operative after the time of the advance dating. Thus, a bill of goods may be sold on April 1 and the invoice dated May 1 (30 days ahead), with the understanding that the cash discount may be taken if the bill is paid within the prescribed number of days after May 1. Such terms would be expressed "2% ten days, 30 days extra"; or "2/10-30 extra," or often "2/10-30." If the bill is paid by May 10, the cash discount may be taken; after May 10, the net amount is due. Trade custom sometimes sanctions the taking of an extra one per cent discount, if such a bill is paid within 10 days of the actual purchase—in this case, by April 10.

A variation of the practice of dating ahead is the *season dating*. Thus, a clothing merchant may be persuaded to place his order early in the spring for fall and winter overcoats, provided that he is assured the bill will be dated to the overcoat season, probably September 1. This practice enables the manufacturer to get his orders in early and to begin the manufacture of his goods with a pretty definite knowledge of the amount of merchandise that will be required for the season. The goods are usually delivered considerably ahead of the time of the dating of the bills, and the retailer may be able to realize substantially upon them before the bill becomes due. Such seasonal dating, unless the practice is abused, is quite advantageous to both parties.

Many firms buy a number of different lots or orders of goods each month from the same jobber or wholesaler, and find it inconvenient to be making separate payments every few days in order to take advantage of the cash discounts. In such cases, all individual monthly purchases may be cumulated on one bill dated as of the end of the month, and the cash discount period, if any, computed from this day. This practice is known as E. O. M. or *end of month* terms. Another practice is to accumulate credit purchases made during the first and last halves of the month on bills respectively dated as of the fifteenth and end of the month. This is known as M. O. M. or *middle of month* terms.

Receipt of goods or *R.O.G.* terms is another method of adjusting the cash discount. When one manufacturer sells goods to customers who are at greatly varying distances

from his shipping point, giving all the same terms of sale, for instance, "2/10, net 30," it may often happen that the near-by customer will have an opportunity to receive and examine his goods in ample time to take advantage of the cash discount, while the far-distant customer would, in order to get the discount, have to pay while his goods were still in transit. To avoid this inequity, some houses make the cash discount operative from the date of the receipt of the goods by the purchaser. The usual custom is, however, that, if the customer does not take advantage of the cash discount, the final time for the net payment remains at the stipulated number of days from the date of the invoice and not from the receipt of the goods. Thus, R.O.G. terms affect the cash discount only and not the full time of credit.

From the statement made in the first part of this section to the effect that terms of sale are somewhat regular and well established within each of the many lines of industry, it must not be inferred that there is any absolute standardization controlling them. Different firms in the same industry will vary somewhat in general policy: the same firm may sell different lines on different terms; and one firm may sell on different terms to different customers; the policy is determined by the character of the respective credits, the value of the respective accounts, the power of the respective bargaining abilities, and so on.

The underlying idea is that the terms of sale allowed must be as favorable as possible to the selling house, and at the same time they must be such as will retain the goodwill of the buyer and enable him to continue to buy and pay on the terms offered. The ultimate time given to pay the account enables the buyer to utilize his credit to finance his business, and the cash discount serves as a reward or premium to induce early payment where possible.

Financial effects of terms of sale.—The terms of sale have considerable effect upon the finances of the business of both the seller and the buyer, and their adoption and enforcement come second only in importance to the task of determining whether to grant any credit whatever to the customer.

The principal effects may be summarized as follows:

I. Effects on the seller—**A. Of the time given for final payment:**

1. Long-term payment makes large working capital necessary, but generally makes sales easier. Short-term cuts down the necessary amount of working capital but also tends to decrease sales.
2. Long-term brings in weaker customers, and their presence tends to increase the credit risk and to make collections more difficult. Short-term keeps the sales confined to those who will, at least, promise to pay quickly; if they do not, collection proceedings may be started soon enough after the sale of the goods to avoid serious losses.

B. Of the cash discount:

1. It tends to produce prompt payment and hence more rapid turnover of capital.
2. It reduces the credit risk by shortening the actual terms of sale.
3. It tends to reduce the costs of collection.

II. Effects on the purchaser—**A. Of the time given for final payment:**

1. Long-term payment lessens the amount of working capital necessary. Short-term necessitates more working capital.
2. Long-term tends to make many buyers somewhat careless concerning the payment and tempts them to use their cash to settle more pressing short-term accounts. Short-term brings the buyer to a quick accounting and makes him take care of the bill promptly.

B. Of the cash discount:

1. It effects large savings for those who are able to take advantage of it.
2. It strengthens the credit rating of those who consistently take advantage of the discount.
3. Desire to take the discount makes a business man buy more cautiously and avoid overstocking.

Buying on credit.—The purchasing department of a large business usually arranges the terms on which goods are purchased; at the option of the purchaser, goods may be bought for cash or on credit. However, in the case of selling, credit must be granted to get business. We have already seen how trade credit can be used as a source of working capital. A concern which pays promptly on or before the date the credit term expires enjoys almost as good credit as the concern that always pays cash. Nevertheless, there is considerable saving in paying cash because of the discounts allowed, and when cash is available, many businesses prefer to discount their bills. Due to the effect of the purchasing policy on the working capital, the general policies with regard to paying bills are laid down by the management and followed by the purchasing department in making contracts.

Saving through taking cash discount.—The actual number of dollars saved through taking the cash discount on a bill of goods may not be large; but when the saving is figured on a yearly percentage basis, it is found to be many times larger than the uninitiated would suspect. A few examples may well illustrate this.

Where a bill of goods for \$1,000 is bought on terms of 2/10, net 30 days, it can be settled for at the end of 10 days for \$980, with a saving of \$20. If the outlay of \$980 at the end of 10 days means the saving of \$20 over the outlay of \$1,000 at the end of 30 days, it is evident that the merchant has saved \$20 on an investment of \$980 over a period of 20 days. Figuring 360 days to the year, or 18 periods of 20 days each, he would accumulate a saving at the rate of 36 per cent a year. Similarly, if the terms were 2/10, net 60 days, the saving would be equivalent to a rate of 14 per cent a year. Terms of 3/10, net 30 days, would give 54 per cent a year; and term of 3/30, net 60 days, would give 36 per cent a year. Other term can be calculated in a similar manner. If the firm places a usage value upon its money, or has to borrow cash to take advantage of the cash discount, then the annual rate for the use of the loan, usually 6 per cent, may be deducted from the gross rate of saving, as shown above, to obtain the net rate of saving.

When savings are figured in this manner, the great value to a business of taking advantage of the cash discount becomes apparent.

The collection problem.—A credit risk having been accepted, it devolves upon the credit manager and his department to follow up accounts and, should the bill not be paid when due, to see that the customer is reminded of his promises and pays his bill. In concerns having many small accounts, the investigation of the credit risk is seldom thorough, and the collection problem is likely to absorb a great deal of the credit department's time. Even when the accounts are comparatively large and are carefully investigated, there are bound to be some customers who for varying reasons do not pay on time. Professor A. F. Chapin in his splendid textbook² has enumerated three objectives of the credit department in the collection of accounts; they are:

1. To collect the debt.
2. To collect the debt and retain the customer's goodwill.
3. To collect the debt *promptly* and retain the goodwill of the customer.

No business concern can afford to neglect its accounts receivable. Money so tied up is not available for active use in the business. While the accounts receivable comprise a part of a concern's working capital, they deserve this classification only when they are paid according to schedule and when the proper turnover of the accounts is maintained. Emphasis has already been placed upon the fact that the amount of working capital required in the business depends greatly upon the liquidity of the current assets. A vigorous and efficient collection policy makes for a more efficient utilization of capital.

The collection procedure.—As soon as a customer becomes delinquent for more than a short period, the collection department takes steps to collect the account. Even though a concern has only a small number of accounts, it is usually wise to develop a systematic collection procedure

² Chapin, A. F., *Credit and Collection Principles and Practice*, p. 432-433.

to which it will adhere in all cases in at least the early stages of collecting. Sufficient flexibility of the system is of course necessary to take care of special cases which are usually not disclosed until one or more efforts have been made to collect the bill. The need of a full appreciation of the vagaries of human nature and of the psychological reactions of different types of individuals to various appeals is as important in the credit department as it is in the sales department, and no cut-and-dried system can replace the personal supervision of the accounts by a trained collection personnel. However, in a large business a good collection system will allow assistants to handle routine cases, such as mailing of notices and follow-up letters and checking up customers' ledgers.

Collection methods.—It is impossible to discuss in detail here the methods and practices of business concerns in the collection of debts. Such a detailed treatment would require a volume in itself. In this chapter we shall give but a brief summary of the more important methods and devices used.

1. *The invoice.*—At the time goods are shipped, it is usual to send an invoice, which itemizes the articles sold and states the terms of payment. Many of the customers pay within the invoice terms and no further collection instrument is required.

2. *The statement of account.*—This provides a convenient means of notifying the customer of the status of his account and also serves as a means of reconciling the records of both debtor and creditor. Frequently the statement has upon its face the sentence, "If found correct, please pay balance indicated."

3. *Formal notices.*—Some concerns 10 or 15 days after the account becomes due send a formal notice calling attention to the fact that the account is overdue and making a request for payment.

4. *Collection letters.*—If the methods previously mentioned do not bring payment, a series of collection letters are sent at regular intervals. Quite often these letters are

form letters and are part of the regular routine of the collection department. Once a customer has responded, giving reasons for non-payment, or has made a partial settlement of the account, it will be necessary to give his account special attention and write special letters which will cover the particular situation.

5. *Use of drafts.*—Some concerns draw a sight draft upon the customer as a means of collection of an overdue account. This means is considered harsher because it discloses the relationship between the concern and its customer to a third party, the bank. It is an endeavor to force payment from a debtor by the threat of injuring the debtor's credit should he refuse to pay the draft. It should be used with a great deal of care because it is quite likely to destroy the goodwill of the debtor.

6. *Personal collection.*—If collectors are well chosen, this method should be productive of good results because of the personal contact with the debtor. However, with the exception of purely local collections and installment collections, the telephone has largely replaced this method.

7. *The telephone and telegraph.*—The telephone provides a cheap and effective means of establishing personal contact with the debtor. It is subject to the disadvantage that the creditor must rely upon the debtor's making payment as promised over the telephone. The person using this means of contact must, of course, be very tactful in order to produce results.

The telegram, because of its semi-private nature, has some disadvantage in that the creditor must be very careful not to make any statement which may be construed as libelous. Its chief advantage lies in the fact that its very use suggests immediate payment.

8. *The salesman.*—Some concerns whose salesmen make frequent calls upon the debtor utilize their salesmen as collection agents. The chief disadvantage here is that the salesman is engaged to sell goods, and his time should not be taken up with collection problems. The salesman, however, can be of great assistance to the collection department because of his personal contact with the debtor and his

knowledge of the debtor's situation, and a report from him may often give the clue to a successful settling of the account.

9. *The collection agency.*—The collection agency is one of the last resorts of the credit manager. It is effective because of the disinterested position of the agency. The debtor knows that the agency has only one interest, and that is to collect the bill and earn its commission. The placing of the account or even the threat to place the account with a collection agency is often effective without further steps because the debtor knows that it is a very bad reflection upon his credit to have "Referred to a collection agency" on his record. Because it means a severance of friendly relationship between debtor and creditor, this method should be used only as a last resort. Sometimes, instead of using an outside collection agency, the concern will maintain its own collection agency within the credit department, using a different letterhead and a different address. This has an advantage in that the control of the account does not pass out of the hands of the credit manager.

10. *Legal proceedings.*—If there seems to be no possible means of collecting the account, legal proceedings may be necessary. Such proceedings are expensive, but the creditor will often go through with them merely as an object lesson to others in the trade who might try to avoid just debts. Quite often, however, the attorney is instructed to use every possible means to collect the debt before suing the account.

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Questions for Study and Review

1. Name and briefly explain six classes of credit.
2. Discuss briefly the duties of the credit manager.
3. What four factors should be considered in the analysis of credit risks?
4. List several sources of credit information classifying them as:
 - a. Direct.
 - b. Indirect.
5. Give seven differences existing between mercantile credit and bank credit.
6. Explain what is meant by *terms of sale*.
7. What is meant by the following terms:
 - a. 2% ten days, net 30.
 - b. 2/10-30 extra.
 - c. C.O.D.
 - d. C.B.D.
 - e. Dating ahead.
 - f. Season dating.
 - g. E.O.M.
 - h. R.O.G.
8. Explain the importance of the savings possible through taking cash discounts.
9. Explain in detail the effect of the terms of sale on both the seller and the buyer.
10. What department in a large business usually arranges for the credit terms on which goods are bought?
11. What are three objectives of the collection department?

12. How does collection department efficiency affect working capital requirements?

13. What are the essentials of a good collection system? Why is such a system necessary?

14. List nine collection methods commonly used before legal proceedings are instituted.

Problems

1. A young man of your acquaintance has heard of an opening in the credit department of a hardware manufacturing company. Before applying for the position, he has come to you for advice, asking in particular just what the nature of the work is in a credit department and what future this field may offer. Briefly answer his questions.

2. A retailer with whom your firm has had no prior dealings asks you to ship him on a credit basis a bill of goods worth \$3,000. What factors would you consider before making your decision? Tell the sources from which you would obtain the information on which to base your judgment, and explain what reliance you would place on each.

3. If a firm borrows money at a rate of 6 per cent in order to take advantage of cash discounts, what yearly percentage of savings will be accomplished under the following terms of sale:

- a. 1%/10, net 30.
- b. 2% ten days, net 60.
- c. 3% ten days, net 30.

4. Explain in detail the difference to the buyer between the terms "2/10-net 30" and 3/30-net 60."

5. A retailing firm located in Los Angeles wishes to purchase a bill of goods from a manufacturer in New York. The retailer's credit standing is perfectly satisfactory, and the wholesaler offers him the usual 2% ten days, net 60. As manager of the retail firm, are these terms absolutely satisfactory to you? If not, indicate the terms you desire from the New York firm and give in detail your reasons for asking them.

6. The X Company, conducting a hardware store in a growing midwestern town, has become very slow-pay, and some creditors have threatened drastic action. Your concern, the largest creditor, has an overdue claim of \$4,000 against the debtor. Analysis of the credit risk shows excessive amounts of receivables and in-

ventory, largely frozen as a result of a temporary slump in business. To make matters worse, the streets of the downtown section where the business is located are being repaved. The concern has been in business for ten years and both bank and trade reports were favorable before the present difficulties arose. Its two competitors are located on the outskirts of the town. Credit agency reports show nineteen other creditors whose claims aggregate \$3,000. The net worth of the business is \$30,000.

a. Outline the credit and collection policy and the collection tools you would employ in harmony with an energetic policy of expanding sales with a minimum of losses.

b. How would your decision be influenced by a rumor that negotiations are under way to establish two hardware stores on a near-by street to which main traffic will be shifted?

CHAPTER XIX

Business Combinations

Combination of business units.—In earlier chapters the formation of various types of business organizations were discussed somewhat in detail. We were concerned in those chapters with the organization of one business unit only, and we dealt chiefly with the ways by which men may seek to associate with one another in a single concern. In this chapter we shall study the various forms of combination, not of individuals, but of two or more business units. We shall undertake to study not only those forms of combination which result in a complete union or fusing of two or more businesses into one *de jure* or *de facto* whole, but also those forms of loose agreement whereby separate concerns agree to act in concert to achieve some particular purpose.

Types of combinations.—There is considerable confusion in terminology with regard to combinations. The popular term for any type of combination which results in complete union is *consolidation*. The word is often applied regardless of whether two or more corporations are actually fused together into one legal unit or whether one has gained control of another through stock ownership. The various terms describing the different types of combinations discussed in this chapter will now be briefly defined.

1. *Consolidation.*—The term *consolidation* means the complete fusion of two or more corporations into a single corporation (See Article 8, Paragraph 86, N. Y. Stock Corporation Law). Under this New York statute, *consolidation* means the forming of an entirely new corporation to take over the two or more combining corporations, and directs the filing of a new *certificate of consolidation* similar

in form to the original certificate of incorporation. The constituent corporations lose their corporate identity.

2. *Amalgamation*.—*Amalgamation* means a fusion of two or more corporations into an entirely new consolidated company. This term is seldom used.

3. *Merger*.—A *merger* is a combination of one or more corporations with an existing corporation, taking and keeping the name of the existing company. The difference between merger and amalgamation is usually of little practical importance.

4. *Sale of assets*.—This method of combination is brought about by the outright *sale of* all or a part of the *assets* of one business to another. The business organization making the sale may or may not go out of existence.

5. *Lease of assets*.—As the term indicates, this method of combination involves the transfer of the *assets* of one business to another *by lease*.

6. *Trust*.—This method, which is of historical interest only, involves the use of a single voting *trust* to control the voting stock of two or more corporations.

7. *Holding companies*.—In a holding company a combination is effected by the acquisition of a controlling interest in the stock of one corporation by another; the legal identity of each is preserved in the process. The acquiring corporation is known as the *parent* or *holding company*; the corporation whose stock is acquired for the purpose of control, as the *subsidiary corporation*.

8. *Pools, gentlemen's agreements, trade associations*.—These are mere agreements between businesses to act in harmony in certain matters to attain a common end.

9. *Community of interest*.—This term generally is used to refer to a state of close harmony in the operations of two or more corporations brought about through the same person or persons on the boards of directors of several corporations, or merely through the influential stock ownership of two or more corporations by one person or closely associated group, *e.g.*, friendly banking interests.

Reasons for combination.—Some of the reasons for combination have been touched upon in Chapter XIII on

“Financing Expansion and Selling Securities.” The more common reasons usually given for combination may be grouped conveniently under the headings of production economies, distribution economies, and financial and administrative economies.

1. Production economies.
 - a. Standardization of products, raw materials, and supplies.
 - b. Utilization of by-products.
 - c. Increased efficiency of plants and equipment.
 - d. Equalized distribution of labor and production.
 - e. Control of sources of raw material and supplies.
 - f. Large scale purchasing.
2. Distribution economies.
 - a. Transportation economies.
 - b. Unification and consolidation of sales forces.
 - c. Development of foreign markets.
 - d. Collective advertising.
3. Administrative and financial economies.
 - a. Development of research.
 - b. Interchange of data and experience.
 - c. Reduction in overhead, especially administrative.
 - d. Reduction in cost by financing on a larger scale.
 - e. Ease in raising additional capital.

Legal requirements for fusion.—Before going further with a study of business combinations, we must briefly consider the practical and legal steps which are necessary to consummate the fusion in a satisfactory manner.

These steps are four in number, as follows:

1. There must be the conception of the idea of fusion by someone whom we will call the *promoter*. He must persuade those in control of each business involved of the advantages of the proposed fusion, and must formulate the plan which will be incorporated into the resolution adopted by the several boards of directors and which will provide the details for submitting the proposition to their respective stockholders.

2. The assent of the stockholders of each company must be obtained either by their unanimous approval, evidenced by signature in person or by proxy, or by the approval of at least two-thirds of all the outstanding shares; the vote is taken at a stockholders' meeting called for the special purpose of accepting or rejecting consolidation.

3. As required by law, the contract of agreement, properly executed with these necessary consents, must be filed in all the proper offices.

4. To complete the fusion, the actual exchange of the certificates of stock of the old companies for those of the new company must be made in accordance with the plan specified in the contract.

The basis for merger.—In arranging a merger, the usual method is to exchange the stock of one corporation for that of the corporations coming into the combination. To a large extent, the basis for exchange in a great many mergers is the market value of the stock of the constituent corporations. This condition is due to the fact that the security holders of the corporations to be absorbed will not consent to the merger unless they see that they are getting at least, dollar-for-dollar value for their shares in exchange. In the last analysis the basis for exchange should be the earnings per share of the corporations combining. The *A* Corporation is to merge with the *B* Corporation. The *A* Corporation's earnings over a period of years have averaged \$4 per share on its stock, while the *B* Corporation's over the same period of years have averaged \$2 per share. If *A* wishes to absorb *B*, it should be able to do so by offering one share of its stock for two of that of the *B* Corporation.

Naturally, the offer to exchange stock cannot be made to each individual shareholder. It is arranged through an agreement between the directors of the combining companies, some of whom are often large stockholders. After the directors have bargained among themselves, often with the assistance of interested bankers, and have reached an agreement as to the basis of exchange, the proposal must be submitted to the stockholders at a special meeting called for the purpose. If the required number of stockholders

(two-thirds under the New York statute) consent, the absorbing corporation issues its stock in exchange, and the merger is consummated. The rights of dissenting minorities will be discussed in a subsequent paragraph.

Consummating a consolidation.—In a consolidation a new corporation is formed to acquire the assets of the constituent companies. If this plan is used, it is customary to capitalize the new corporation on the basis of the combined average earnings of all the constituent companies and to add to the earnings figure so obtained the increased earnings due to the economies of consolidation. The stock of the consolidated company is then exchanged on an earnings basis for that of the constituent corporation. The bargaining goes on usually between the promoter and his banker and the directors of the constituent companies, ordered and advised by their bankers. Since an amalgamation contemplates the dissolution of all the constituent corporations, leaving only the consolidated corporation to function, the consents of the statutory number of the stockholders of all the constituent corporations must be obtained.

The option method of promoting a consolidation.—Under the option method of promotion a promoter, through separate dealings with the directors of the corporations that he wishes to bring into the consolidation, obtains a price for which the corporation will sell its properties. Armed with these options, he will probably approach an investment banking house and ask them to underwrite the promotion of a consolidated company to take up the options. Once this has been done, he again approaches the directors of the constituent corporation, offering them stock in the consolidated corporation in lieu of the cash that will be needed to take up the options. Should he fail in this arrangement, it will be up to the underwriting banker to take the stock and furnish the cash to take up the options.

The bargain method of consolidation.—Under the bargain method the promoter starts with an estimate of the total earnings of a consolidation, which will include certain companies he plans to approach. He capitalizes these estimated earnings at a rate which seems to be best from the point of view of marketing the stock. Each company is

then approached and a bargain made. The promoter tries to bring each company in at the lowest possible price so that there will be stock left over for himself. In such a bargain, all sorts of inducements are likely to be offered to bring certain corporations to terms. For instance, lucrative positions in the new consolidated company may be offered to the officers or the directors of some of the corporations to induce them to accept certain terms. As a rule, the more important companies are approached first, because their presence in the consolidation may exert a powerful influence upon the smaller corporations and cause them to follow suit.

All consolidations a matter of bargaining.—It has been shown that consolidations are worked out on the basis of mutual agreement, regardless of whether the option or bargain method is used. Since this is the case, it must be realized that no established rule or standard procedure can be set down here regarding the practice to be followed. The general conditions at the time, the importance of the companies, the location of their plants, the desirability of obtaining the services of a certain executive, the condition of the stock market—all of these and many other considerations come up around the bargain table and result in compromises and special arrangements, which make it practically impossible for an outsider to even guess at the exact procedures followed and the real basis for the consideration paid for various properties.

Sale of assets.—A sale of assets frequently results in a merger. While the sale may be for cash, as in the case of the purchase in May, 1925, of all the assets of Dodge Brothers, Inc., by the banking house of Dillon, Read & Co., it may be consummated through an exchange of stock.

A sale of assets, however, may not result in a merger, for the old company may continue to exist. The selling company, also, need not be a corporation, for partnership assets may be purchased either for cash or stock. An example of the sale of assets by a joint-stock company to a corporation occurred when the Adams Express Company on June 30, 1918, sold its entire physical property to the American Railway Express Company and received payment in stock.

The Adams Express Company did not go out of existence, but operates today as a general management investment trust.

Often merely a department is sold; for instance, in April, 1926, the Manhattan Electrical Supply Company sold its entire battery business, including factories in Jersey City, N. J., and Ravenna, Ohio, to the National Carbon Company.

Lease of assets.—The method of bringing about a corporate combination by the use of the lease has been extensively used by railroads in their expansion programs. It provides the same unity in operations as a merger and does not involve the financial expense of acquiring a controlling stock interest or outright purchase.

A lease practically gives a temporary ownership of the property. There is created a personal property right called in legal terminology a leasehold. Where one corporation leases its entire assets to another, the lessor corporation relinquishes practically all control over the property but retains its corporate existence.

A lease of corporate property is usually a lengthy document containing many clauses most of which can be grouped under the following headings:

1. *A description of the property.*— Since some of the property will change its form from time to time to keep pace with the march of scientific progress, it will be necessary to supplement the usual descriptive clauses of the original property with new inventories and appraisals made periodically or as occasion demands. Thus, the lessor will be able to follow his leased assets if the lessee fails to comply with the terms of the contract, as well as to locate his property at the termination of the lease. To illustrate, a city transportation system may have been leased years ago as a rail system with horse-drawn vehicles. In the normal march of progress, these have been changed, perhaps, to steam-driven buses; then, to an overhead electric trolley system; then, an underground cable or a third-rail system; and, finally, perhaps, into a radio-controlled system, at the expiration of the lease. In any case, the lessor regains possession of the improved property.

2. *The period of the lease.*—Incidentally, this brings to our attention the outstanding characteristic of the leasing method as compared with the sale of assets, the consolidation, or the merger method; the leasing method requires the continued existence of the organization, which is usually absorbed according to any of the other plans. The one exception is that the corporation selling its assets may continue its own existence, distributing the income on the proceeds of the sale to the holders of its securities. As in the case of sale of assets, the lease provides a simpler process than complete fusion by merger or consolidation, for no recapitalization is required and the nominal identity of both old organizations remains undisturbed. When the lease is for a long period of time, there is, in effect at least, a complete fusion. For example, the New York Central has leased all the property of the West Shore Railway for 475 years. In the early nineties, the Pennsylvania Railroad controlled the properties of nearly fifty railroads through leases, some of which were perpetual contracts. The most common period for long-term leases is 99 years; this term was established by court decision in some jurisdictions because it was considered a wise policy to require property to be returned to the full control of owners of title at least once in two or three generations. If a lease were made perpetual, we should have the anomaly of an owner of title who would never be able to regain possession of his property and of a possessor of property who would never be able to pass title.

3. *The compensation in lease agreements.*—A majority of leases provide for the payment of a fixed money rent to the owners of the leased property, but some make the payment contingent upon the earnings received from its operation. This ratio in favor of *fixed rental* is due, no doubt, to the influence of the lessor, who is more often in a better position to dictate terms, since he possesses the property. When he is in financial difficulties and eager to lease, then the lessee or prospective operator is the party being sought, and he is in a better position to dictate a *contingent rental* plan. The history of leases, especially railroad leases, teaches the disadvantage of the *fixed rental* type of lease which, no matter how carefully the amount of rental has been computed

at the inception of the lease, becomes burdensome in later years and is the direct cause of many financial failures. Among the more remote examples of such failures, we find that only three of the 25 leased lines of the old Wabash Railroad system at the time of its failure in 1884 provided an income sufficiently large to pay the rental of their respective lessors. Among recent examples is that of the Interborough Consolidated Municipal Railway system in New York City, whose financial difficulties were due, in part at least, to the abnormally high rentals of its leased elevated lines. In the reorganization which followed the failure of this holding company, the lessors of the elevated roads were forced to accept a reduced rental.

Regardless of whether the total rental is based on a fixed or contingent basis, corporate leases—almost without exception—provide that taxes, insurance, expenses of maintaining the organization of the lessor, and interest on the indebtedness of the lessor, shall be paid by the lessee. It is the lessor who insists upon the inclusion of the insurance and of the expenses of the lessor-organization clauses, in order to safeguard his investment of property. But it is usually the lessee or consolidating company that desires the obligation of paying the taxes and interest on the bonds of the landlord's leased business as a part of the rental. For what assurance has the tenant, if he pays the rental money direct to the landlord, that the landlord will pay the taxes and bond interest promptly to the proper outside parties who, in the last analysis, have a better claim on the property than either the lessor or the lessee? In addition to these elements in the rental of all the assets of one corporation to another, the lessee usually agrees to pay a specified dividend on the stock of the lessor outstanding at the time of execution of the contract. Sometimes the contract goes a step further and provides for the lessor a share in the profits of the operating company. Such a lease would be a combination of the fixed and the contingent rental types. Often these participating profits are arranged on a sliding scale in order to permit the stockholders of the old corporation to share in the increase in profits due to the expected economies of consolidation. Well-drawn contracts

will also provide for the maintenance of the leased property, especially if the leasing period is short. If the lease is for a long period, the operating company will keep the property in constant repair to maintain a high rate of profit for itself; but, if it is due to surrender the property to its owner, the company will find it easy to neglect maintenance for the last year or two and thus increase its own net income.

When the rental is contingent rather than *specified* and *guaranteed*, it is usually varied with the income or the output. For example, the participating lease spoken of in the last paragraph is one which varies with the income or net profits of the business. In businesses with wasting assets, such as mining operations, the terms of the lease usually require the payment of a certain sum per ton on the output of ore, with a specified minimum rental. This minimum fixed rental will tend to prevent a competitor from leasing a property and then allowing it to stand idle while he seeks to make his own free from competition. Leases of railroad properties are usually based on fixed rental terms; but, when made contingent, the rental varies according to (a) the volume of traffic interchanged, (b) the gross earnings, or (c) the net earnings of the leased lines.

Advantages of the lease to the lessee.—

1. The competition of the owner of the leased property is eliminated. As long as the consolidated business does not become monopolistic nor engage in restraint of trade through the operation of the lease, this is an advantage to the lessee to which the consuming public cannot object.

2. The lessee's business is expanded by the acquisition of a going business without incurring the cost and delay of construction in the presence of competition.

3. The lease eliminates the necessity for financial readjustments and reorganizations. In complete fusion by merger, there usually is necessary an increase in capitalization of the continuing company. If the fusion is by consolidation, the financial structure of all corporations involved is altered; if by the sale of all the assets, the purchasing company may need to increase its capitalization, while the selling corporation may continue or dissolve. But,

under the leasing method, the capital structure of neither corporation is involved. Here the effect on the organization of the operating lessee will be an increased gross income from which increased operating expenses, including the current lease rental charges, will be paid.

4. The lessee corporation is able to expand the business without the necessity of sharing its control with others. If the nature of its business, or its present financial structure, is such that additional capital appears to be obtainable only by the sale of voting stocks, then the lease will be a satisfactory alternative. The owners of the leased property will be in the position of bondholders; that is, creditors who alone are able to demand compliance with the lease contract which seldom, if ever, permits any voice in the management of the operating company.

5. When a lease with a fixed rental is consummated just before or during a period of increasing business, the future operating company will reap the harvest of increased profits due to the economies of consolidation and greater managerial efficiency, while the owner must be content with a rental which appeared to be a reasonable maximum when the contract was executed. *Please grant it?*

Disadvantages of the lease to the lessee.—

1. Leased property is not a good security for loans to pay for improvement which will increase the future value of the property or for any other corporate purpose. However, there are instances where leases have been used as security by making them subject to lien. The Interborough Rapid Transit Company has an issue of First and Refunding Mortgage Gold 5's, of which an issue of 300,000,000 was authorized, secured by a first lien upon all the leasehold and other rights of the Interborough Company, principally consisting of municipally owned subways and the Manhattan Elevated system of the City of New York. In the real estate field, first mortgage leaseholds are not uncommon. For instance, an authorized issue of \$5,000,000 worth of bonds of the Bankers Building, Chicago, was secured by a first mortgage on a leasehold estate in land and a 41-story office building located in Chicago.

But mortgages upon leaseholds are not always acceptable as security, and for that reason the lessee company should be wise enough to provide proper clauses in the lease at the time of its execution. These clauses should provide: (a) that the landlord shall issue stocks or bonds, from time to time, at the request of the lessee, to meet the cost of improvements and additions to the lessor's property; (b) that the lessee shall determine not only whether stocks or bonds of the lessor shall be issued, but also the rate of interest or dividend. The lessor, however, should have the power of veto, which, if exercised, will cause the matter to be referred to the board of arbitration provided for in the lease.

2. When a lease with a fixed rental is consummated just before, or during, a period of declining volume of business, the lessor will be within his legal rights when he demands his rental, whether it has been earned or not. If this fixed charge is defaulted, the consolidated structure of the operating company will fall, unless it is able to make up the deficit from the profits on other properties.

3. If the certainty of future control is a requirement of the success of a consolidation, a lease is a questionable means of effecting a fusion of businesses. Like the combatant who, once having had his traditional enemy in his power, relented and released him only to discover later to his sorrow that the enemy had returned to the attack, so the stockholders of the still-existing lessor corporation may find some excuse for breaking the lease contract and renewing its ruinous competition. The time, the effort, and the wealth that the lessee spent to build up a successful business have been wasted. The possibility that the stockholders of the dormant lessor corporation are often able to return to the attack and disrupt a fusion is directly traceable to their unusual rights as minority stockholders outlined in the next paragraph.

Rights of minority stockholders.—Whether a fusion be effected by merger, consolidation, sale, or lease, dissenting stockholders always have certain statutory and equitable rights which protect them from the not always honorable motives of a designing majority. According to the statutes

of the State of New York, in the case of consolidation, "if any stockholder not voting in favor of such consolidation, shall, at such meeting, or within twenty days thereafter, object to such consolidation and demand payment for his stock, such stockholder or such new corporation may have such stock appraised" by a board appointed by the supreme court of the state. The corporation will then be required to pay not only the appraised value of the stock to the dissenting stockholder, but also the charges and expenses of the appraisers.

So much for the statutory rights of the minority stockholders; their equitable rights seem less clearly defined, because of conflicting decisions in different judicial districts. The consensus of opinion would seem to indicate that, when a business is a prosperous going concern, the unanimous consent of the stockholders is necessary to consummate a lease of all the property of the corporation, on the ground that every stockholder has the inherent rights (a) to have his corporation managed by directors whom he can help elect, (b) to participate in dictating the broad policy of his corporation, and (c) to receive a share in the profits in proportion to the prosperity of his company. He cannot be forced to accept a fixed rental. A recent decision that illustrates the operation of these inherent rights is that affecting the property of the Detroit, Toledo & Ironton Railroad Company. Of the voting securities of this company 97 per cent had consented to a lease of all its assets to the Ironton & Toledo Railroad, Inc., for a fixed rental; but the remaining 3 per cent obtained a temporary injunction retaining the lease for the reasons enumerated above. This ruling was later reversed by a higher court but affirmed, in effect at least, by a decision of the Interstate Commerce Commission denying the request of the Ironton & Toledo to acquire control of the Detroit, Toledo & Ironton Railroad by lease.

Court opinions seem to agree that, as a step toward the dissolution of a corporation, a majority of the stockholders can lease all the property for a reasonable length of time.

Trusts.—The term *trust* is applied by the press and public to almost any large combination; and where it is so used,

there is generally an implication that the trust is a monopoly capable of exerting control over prices and service. As a matter of fact, the trust as a form of combination no longer exists. From 1885 to 1890, several groups of corporations through the rise of a voting trust combined in the following manner. In the voting trust the stockholders of a single corporation deposited their stock in the custody of designated voting trustees, who issued voting trust certificates in exchange. The stockholders retained all rights to their stock except that of voting power, which was delegated to the trustees temporarily; that is, during the life of the trust agreement. The trust was but the next step to increase the sphere of control. Two or more corporations formed voting trusts within their several independent organizations, but each designated the same individuals for voting trustees. This vesting of authority in a common management placed that management in a position to dictate policies for each of the several corporations that had as its primary purpose the welfare of all rather than the welfare of itself.

Under this form of organization it is necessary for the combining companies to surrender their entire control into the hands of trustees, and this action becomes subject to attack because it is ultra vires. Objecting minority stockholders may insist on their inherent right to help determine the broad policies by which their chosen directors shall be guided. As a method of forming combinations the trust was abandoned with the dissolution by the courts of the Sugar Trust in 1890,¹ and of the Standard Oil Company of Ohio in 1892.² The grounds for the decision in the North River Sugar Refining Company case are interesting for they hold the trust form illegal without reference to the question of monopoly. The chief points brought out by the court in its decision may be summed up as follows:

1. That, despite the allegation of the defendants that, although the corporation has become a member of a combination which possessed complete control over it, such a

¹ *People v. North River Sugar Refining Co.*, 121 N. Y. 582 (1890).

² 49. Ohio St. 137 (1892).

condition arose through the action of the stockholders and not of the corporation (and therefore the penalty of dissolution should not be visited upon the corporation), the court held that there might be corporate conduct without formal corporate action, and that the stockholders, in acting collectively, as an aggregate body without a single exception, had reached results clearly corporate in character, and could not escape the consequence of their acts by pleading innocence of a convenient fiction, the corporation. This disposed of the question as to whether the North River Sugar Refining Company had participated in the creation of a trust.

2. That the defendant had accepted from the state the gift of corporate life only to disregard the condition under which it was given; and that it had received its powers and privileges merely to put them in pawn; that it had given away to an irresponsible board its entire independence and self-control.

3. That the stockholders of the corporation had parted with the control which the charter gave them and the state required them to exercise.

4. That the corporation, in helping to create an anomalous trust, that was in substance a partnership of several separate corporations, was violating the law which forbids corporations to enter partnerships.

Holding companies.—A pure *holding company* is a corporation organized for the purpose of acquiring primarily the voting stocks and other voting securities of various corporations. The securities of the corporations to be controlled are obtained either by a direct exchange for those of the holding company or by a purchase for cash which has been obtained previously by the sale of the securities of the holding company to the security-buying public. The ownership of these voting securities gives to the holding company the right to elect the various boards of directors and thus control their policies just as successfully as if all had been fused into one corporation. The pure holding company is not an operating company. Its management is concerned chiefly with establishing policies, leaving the details of ex-

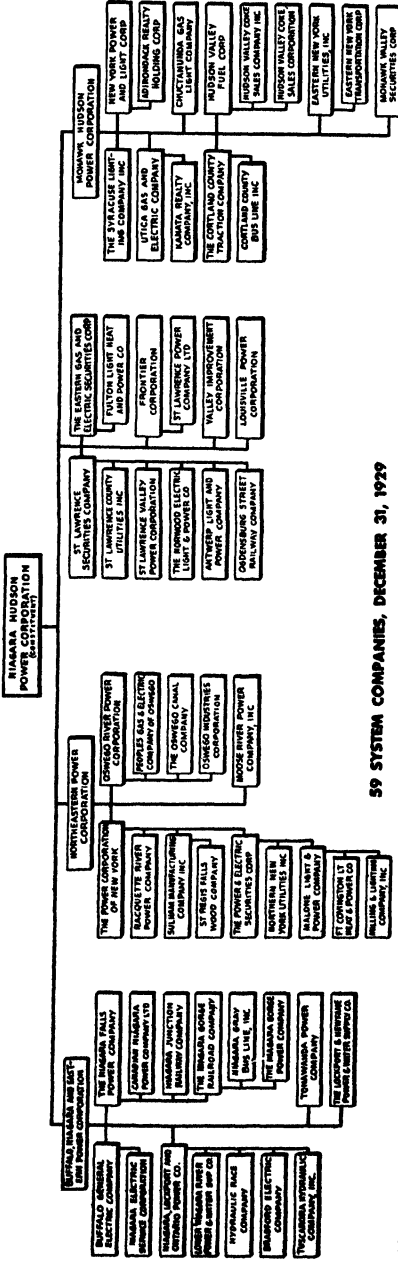
ecution of those policies and the industrial operations of the properties to the experts in each company. Such a company is the United States Steel Corporation. However, some of the largest holding companies are also operating companies; for instance, the American Telephone & Telegraph Company operates its Long Lines Department directly, and the business from it in a recent year was over \$100,000,000. The Niagara Hudson System, a chart of which appears on page 385, is an example of a large network of corporations which has undergone some simplification. It must not be thought that ownership of all or of even a majority of the voting stock is necessary for control. So-called *working control* is generally obtained with substantially less than the majority of voting stock.

Advantages of holding companies.—During the last decade, the holding company has become increasingly important as a means of effecting combinations of corporations. It has been especially popular in the public utility field, but has by no means been limited to this business, being used extensively in large industrial combinations. This development of the use of the holding company has been due partly to the necessity of having some suitable means of uniting incorporated businesses that were domiciled in many states. As a method of combination, the holding company possesses many advantages, some of the more important of which are stated and briefly explained below.

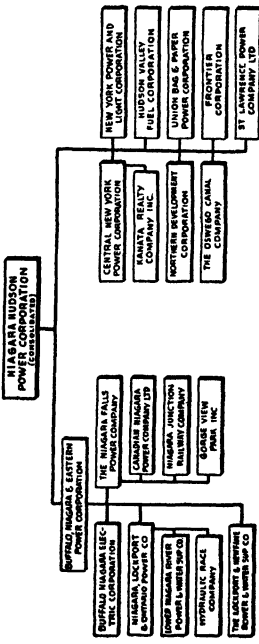
1. Many states require the consent of two-thirds, three-fourths, and even greater proportions of the stock of a corporation to change the capital structure of the company. A minority of the stockholders of an existing operating company could easily prevent the expansion by withholding their approval. But if a bare majority of the stockholders were to incorporate a new holding company and exchange their share of the old securities for stock of the holding company, with a capitalization great enough to acquire the business in question, the objecting minority would be impotent to do anything legally to prevent the proposed combination.

2. No state allows a corporation to engage indiscrimi-

NIAGARA HUDSON SYSTEM PROGRESS IN CORPORATE SIMPLIFICATION



59 SYSTEM COMPANIES, DECEMBER 31, 1929



20 SYSTEM COMPANIES, FEBRUARY 1, 1938

nately in many kinds of business. For example, New York State does not allow a business corporation to perform the functions of a bank, a trust company, an insurance company, or a railroad or other transportation company. Yet a holding company, specifically authorized as it always must be to hold stock of other corporations, is able to accomplish the same results through stock ownership of legally constituted independent units. This advantage will be discussed more fully later in the present chapter under *Integration in industry*.

3. A holding company can be organized as a parent company to avoid adverse state legislation on *foreign corporations*. It is then in a position to organize separate *domestic corporations* in each of the states which have placed undesirable restrictions and burdensome taxation on corporations of other states.

Aside from the legal advantages, there are others of a financial or an economic character. Not the least of these is ease of formation.

4. No other form of combination, thus far discussed, (a) produces quicker results, (b) requires less legal entanglement, and (c) gives the same stability when weighed against time and legal requirements. All previous plans require the consent of large majorities of stockholders. Time, often in addition to prolonged effort, is required to get such permission. ✓The holding company plan, on the other hand, requires not more than a majority of the stock, and frequently less gives control, as we have learned in a previous chapter. All plans thus far discussed are handicapped by possible litigation with a non-consenting minority protected by statutory rights; under the holding company plan, less than a majority of the stockholders can seldom effectively object.

5. The holding company provides a suitable organization for raising most of its funds. Through the device of collateral trust bonds, it is able to finance not only its own subsidiaries but also other corporations from which it obtains valuable contracts for its operating subsidiaries. It can appeal to investors more successfully than the average

non-holding company: first, with probably the most fundamental of investment principles, "Don't put all of your eggs into the same basket" (the securities of a holding company are usually backed by a pool of the securities of many other corporations); second, with the effectiveness of its management.

6. This effectiveness of management or economy in the centralized control of large amounts of capital is probably the greatest advantage of the holding company. The executives of the holding company are the most successful executives from the subsidiary organizations. The subsidiaries are the training camps where many executives are being trained simultaneously, and the most efficient chosen. In the non-holding type of corporation only one set of executives can be trained at a time, and this one set is in the position of the cowboy whom, once in the saddle, the bucking bronco finds it difficult to unseat. The centralized control of large amounts of capital gives to the holding company the usual economies of consolidation mentioned in the previous chapter. But, in addition to these economies, the holding company structure provides for a centralization of financial control which is unparalleled in any other private corporate organization. The capital amassed by, and now under the control of, the board of directors of the United States Steel Corporation, a holding company, is tremendous. The greater the number of combinations effected within a holding company, the more concentrated the centralized control will become, yet the legal position is firm so long as the organization is non-monopolistic in character and not in restraint of trade.

7. The holding company provides a better type of managerial organization for meeting varying local conditions which could not be met so easily through the line organization of a single corporation. The board of directors of the distant subsidiary have the executive authority to make changes which local conditions warrant, but which a branch office superintendent would be unable to accomplish until authorized by a distant management. The distant management, however, is looking at the problem through glasses

tinted with the local color of its own territory and cannot readily be persuaded to approve plans which seem inconsistent with its own experience.

Disadvantages of the holding company.—In spite of its advantages, the holding company has come in for considerable criticism. Much of this criticism may be traced to the general urge for economic reform brought about by the business depression which followed the stock market panic of October, 1929. The failure of the tremendous Insull utilities combination and the depreciation in value of the securities of most of the large public utility holding companies seriously disturbed public confidence in this form of combination and have caused agitation for strict governmental control of public utility holding companies. The disadvantages of holding companies may be roughly classified into three groups: (a) disadvantages of the holding company as a method of corporate combination, (b) disadvantages to creditors and minority stockholders of the subsidiary corporations, and (c) disadvantages to the consumer. Some of these disadvantages will now be stated under their appropriate classifications.

A. Disadvantages of the holding company as a method of combination.

1. *Overcapitalization.*—Holding companies often acquire control of other companies by purchasing stock in the market at current market values, and if the acquisition is made in a period of stock market boom, serious overcapitalization of the holding company may result. Failure or capital reorganization is almost sure to follow as soon as earnings decline.

2. *Duplication of taxes.*—The subsidiary corporations pay a Federal income tax upon their profits, and the holding company will also pay a Federal income tax upon its profits, which are represented by the dividends received from the subsidiary corporations. In addition, a foreign holding company licensed to do business in a state in which one of its subsidiaries is incorporated will in all probability be called upon to pay some form of state income or stock tax al-

though the subsidiary is also paying taxes to the state government.

3. *High overhead costs.*—Maintaining separate corporations requires separate officers and administrative forces; moreover, each subsidiary must render reports to governmental bodies.

B. Disadvantages to creditors and minority stockholders.

1. *Excessive dividend disbursements.*—The holding company's earnings are dependent upon dividends paid by the subsidiaries. In times of business depression, the board of directors of the subsidiary, since it is controlled by the holding company, may vote larger dividend disbursements than the condition of the subsidiary will warrant in order that the holding corporation may be able to pay interest on its bonds and dividends on its preferred stock.

2. *"Upstream" loans.*—"Upstream" loans are loans to the parent company made by the subsidiary. Using its power over the subsidiary, a holding company may force the subsidiary to loan money to it. Such loans are sometimes made when the subsidiary needs all the cash it has, and in most cases the loan itself is an ultra vires act on the part of the subsidiary management.

3. *Diversion of subsidiaries' business.*—In order to bring about unification of operations which will achieve the greatest efficiency and economy, a holding company management may find it advisable to discontinue certain operations of a subsidiary or to confine the subsidiary to one product. However advantageous this may be from the standpoint of the holding company, it may result in loss of goodwill and reduced profits, to the detriment of the subsidiary's creditors and minority stockholders.

4. *Influence on prices.*—The holding company may through its control over the subsidiary management fix prices on subsidiaries' products to other subsidiaries at a discount, causing lower profits for the subsidiaries minority stockholders.

5. *Management and service fees.*—Holding companies occasionally have management departments and sometimes separate management subsidiaries, and make contracts with

a subsidiary for management services. If the fees for these services are reasonable, there are decided advantages to having them performed by the skilled staff of the management corporation. In some cases, however, excessive fees are charged merely as a means of extracting further profits from the subsidiary. Since such fees represent operating expenses of the subsidiary, they provide a means of increasing the income to the parent corporation without the necessity of sharing it with the minority stockholders.

C. Disadvantages to the consumers.

1. *Lack of local management.*—While holding corporations usually emphasize the fact that the locality of the district served is represented in the management, the necessity for uniformity of operating policies means that the local management must operate within limits established by the central management. Proper expenditures for improvements and extensions of service are usually subjected to the approval or concurrence of the holding company, and may be delayed because of the financial needs of other subsidiaries in no way serving the local community. Naturally, the private holding company management will not have the grasp of local problems and needs possessed by an independent, local board of directors.

2. *Interference with local rate adjustments.*—The highly paid legal department and legislative lobby of the holding company is always at the service of the subsidiary in resisting any attempt on the part of customers to obtain lower rates for service.

3. *Diversion of funds to other localities.*—The dividends on the stock of local subsidiaries are sent to a distant city where the main office of the holding company is located, and therefore do not increase local purchasing power. Frequently, all surplus cash of the subsidiary is kept by the holding company instead of the local bank.

Federal Regulation of Public Utility Holding Companies.
—In 1935 Congress enacted the Public Utilities Act, which after defining a holding company as being one which holds 10 percent or more of the voting securities of a public utility

company engaged in the electric or gas business, required all such holding companies to register with the Securities and Exchange Commission, prohibited the issuance of any new securities or changing the rights of existing securities until such registration has been completed. The general purpose of the Act was to bring about a simplification of complicated holding company structures and to limit holding companies to a single integrated system. The Act defines an integrated system for electric light and power public utilities as "one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation." It also prohibits a subsidiary from extending credit to a holding company and prohibits a holding company from making service, sales or construction contracts with an associate public utility company and subjects any subsidiary to regulation of the Commission in making any such contracts with an associate company. While the apparent purpose of this legislation was to correct the complicated structures of existing holding companies it is perhaps well to note here that voluntary simplification has been process for over a decade. Conditions throughout the country differ so widely that it may be questioned if it will prove possible to achieve regulation in the best interests of the public through the stipulations contained in the present Act. An example of voluntary simplification may be seen in the comparative chart of the Niagara Hudson System reproduced on page 385. The Act contains additional details on regulation, discussion of which is beyond the province of this text.

✓ **Integration in industry.**—Expansion of corporations is often for the purpose of *integration*, which may take two forms: vertical and horizontal. Where a corporation seeks

to control all the sequential steps from the production of the raw material until the time when the product reaches the consumer's hand, we have what is known as *vertical integration*. The United States Steel Corporation with its many scores of subsidiaries is an excellent illustration of the process. It controls mining companies; railroads; steamship companies; manufacturing companies; and an export company. Another splendid example of vertical integration is the Ford Motor Company, which, through its control of mines and other sources of raw material, of railroads, and of agencies, has gone a long way toward achieving vertical integration.

Horizontal integration represents expansion by the acquisition of concerns operating similar businesses on the same plane of activity. A splendid illustration of horizontal integration is given us by the General Motors Corporation, which has expanded until it traverses almost the entire field of automobile manufacture, producing cars in almost every price class. The General Foods Company and Standard Brands, Inc., offer further examples of horizontal integration.

Naturally, the holding company form of combination offers the best method of achieving vertical integration, because it is practically impossible under the statutes of any state for a single corporation to engage in the varied activities necessary to achieve complete vertical integration. The laws of a great many of the states, however, allow the creation of holding companies, which may, through stock ownership, control and combine under a single man all the various stages in integration.

Among the advantages of vertical integration, we find: (1) elimination of the middleman's profits, (2) assurance as to the quality of the supplies, (3) certainty of obtaining materials when needed, and (4) most of the economies which have been named in an earlier paragraph on *Reasons for consolidation*.

Among the advantages credited to horizontal integration are savings in overhead and selling costs and most of the general economies of large size referred to above.

• Pools, gentlemen's agreements, and trade associations.—Agreements to accomplish some particular purpose or purposes, such as *trade associations* and *pools*, are loose types of combination. *Pools* are usually formed to accomplish the control of prices through agreements (1) to limit the supply, (2) to divide up territory, and (3) to regulate competitive bidding. These purposes are illegal as far as domestic trade is concerned, though they are encouraged by legislation as far as export trade is concerned.

Trade associations are formed for a great variety of purposes. Some of these are: (1) to provide a credit exchange bureau, (2) to establish uniform trade practices, (3) to advertise the product generally. Trade associations are legal and have been encouraged by the United States Department of Commerce just as long as they do not engage in price-fixing activities.

Community of interest.—Operating harmony and the serving of mutual interests are often gained through interlocking directorates. These are permissible except where directly prohibited by statute, as in the case of the Clayton Act, which forbids interlocking directorates among railroads. Oftentimes common banking interests result in establishing close harmony among separate corporations.

Anti-trust statutes.—Laws directed against monopoly and restraint of trade have been enacted by both the states and the Federal Government. These act not as restraints upon corporations' combining but rather upon their engaging in monopolistic practices. Mere size is not the factor which determines whether or not a combination violates the statutes. In interpreting the Sherman Anti-trust Law, the United States Supreme Court has established the principle of the "rule of reason"; that is, not every contract or combination which restrains trade (and all do in some degree restrain trade) is illegal, but only those which *unreasonably* restrain trade come under the ban of the law.

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Questions for Study and Review

1. Name and briefly explain each of the various types of business combinations.
2. State ten reasons for consolidation, arranging them under production, distribution, and administrative economies.
3. What is meant by the option method of promoting a consolidation?
4. Describe the bargain method of consolidation.
5. Give five advantages and three disadvantages of the lease as a method of corporate combination.
6. Under the New York Statutes, what rights has the minority stockholder who objects to a consolidation?
7. How was the voting trust used to effect corporate combinations? Upon what grounds was this form of combination declared illegal by the courts?
8. What is a holding company?
9. Name eight advantages of holding companies.
10. Classify and illustrate the disadvantages of the holding company:
 - a. As a method of combination.
 - b. From the standpoint of creditors and minority interests.
 - c. From the viewpoint of the consumer.
11. What is meant by (a) vertical and (b) horizontal integration? What form of corporate combination seems to present the best method of achieving integration?

Problems

1. The *A, B & C Corporation* desires to merge with the *X, Y & Z Corporation*. While two-thirds of the *A, B & C* stockholders consent to the merger, it appears that only a bare majority of the *X, Y & Z* stock will be voted in favor of the merger. (The statutes require the consent of two-thirds of the voting stock for a merger). How can the two corporations be brought

under unified control? Would your answer be changed if only one-third of the stock of a desired corporation could be acquired?

2. Show how, by use of the holding company, assets aggregating a tremendous amount are often controlled by a nominal investment.

3. Two large metropolitan department stores desire to combine their delivery systems. Assuming that their forms of organization may not be the same, advise them of one or more methods by which they can accomplish their purpose, and point out the advantages or disadvantages of each plan.

4. On November 15, 1906, the United States Government brought suit against the Standard Oil Company of New Jersey, a holding company with 70 subsidiary corporations, charging violation of the Sherman Anti-trust Act. On May 15, 1911, the Supreme Court confirmed a decision of the circuit court enjoining the Standard Oil Company of New Jersey from voting the stock of 37 of the defendant companies (the case against 33 having been dismissed) and enjoining the defendants from entering any like combination which would restrain interstate commerce in petroleum and petroleum products. Discuss the recent merger of the Standard Oil Company of New York and the Vacuum Oil Company, bearing in mind that both of these companies were defendants in the above suit.

5. Corporations *A*, *B*, and *C* are being consolidated into a new corporation *X*. Common stock of the *X* Corporation is to be offered to the three corporations in payment for their assets. The promoters and bankers will retain ten per cent of the total stock for their services. The corporation will be capitalized at 12 per cent, which in the judgment of the bankers represents a fair rate of return on the business. It is estimated that the present earnings of the three corporations will be increased as a result of economies of consolidation by \$80,000.

A study of the income statements of the three corporations disclosed that the average earnings over the past five years were, respectively: Corporation *A*, \$200,000; Corporation *B*, \$125,000; and Corporation *C*, \$75,000.

How much stock will be given to each corporation if:

a. Shares are to have a par value of \$100?

b. No-par value stock is to be used and the shares are to be sold at a market price of \$50?

CHAPTER XX

Business Failures and Reorganizations

Business failures and financial difficulties.—Many concerns become involved in financial difficulties from which they may recover or which may cause them to fail. Financial difficulties are usually indicated by inability to pay bills or continued failure to earn a profit. Either situation requires drastic treatment if the business is to be made a going concern again. Such treatment may be administered voluntarily by the owners or managers, or may be brought about through action taken by the creditors.

Not every business which finds itself unable to meet its current liabilities or pay interest on its bonds is allowed to fail completely—that is, its assets liquidated for the benefit of creditors; sometimes skillful readjustment on the part of its management is accomplished with such speed that creditors are willing to forbear until the affairs which have brought the business to its precarious state have changed for the better. The creditors themselves are usually far more interested in seeing the business continue as a going concern than they are in having its affairs wound up and its assets liquidated. This attitude results from recognition of the fact that the assets of a business often have little value when divorced from a going concern. To get their money out of a business, creditors often find it to their interest to give the business an extension of time in which to pay its bills, or even to take the initiative in gaining control of the business and in striving to put it on its feet again.

Where there is a great public interest involved, such as exists in the case of railroads or public utilities, it is imperative that the company be reorganized so that the service upon which the public depends may be continued by the reorganized company; but the company must be maintained during the period of reorganization.

When there is no chance of rehabilitating a business which has fallen into financial difficulties, it must be liquidated. If there are debts, they, of course, must be paid before any liquidating dividends are paid to the stockholders. If the assets appear to be less than the amount due the creditors, or if the firm has been unable to pay its bills, it is likely that bankruptcy proceedings will be instigated either voluntarily by the owners or necessarily by the creditors.

The purpose of this chapter shall be to discuss not only the causes of failure, but also, briefly, the manner in which various readjustments and reorganizations are brought about and the procedure followed where complete failure brings the business before the courts in bankruptcy proceedings.

Causes of failure.—The causes of failure in a specific situation are, like the reasons for success, difficult to isolate. Failures frequently seem to occur from a “complication of diseases” rather than from one outstanding cause. Lack of working capital is often named as a cause for failure; however, it is merely a symptom of some more deep-rooted ailment which has brought about the resulting condition.

While incompetence on the part of the management may be cited as the cause of practically all business failures, as expressed in the words of A. S. Dewing,¹ “. . . after the most exhaustive and illuminating analysis of economic causes, there must always stand out the fact that a business fails because the managers do not possess the necessary intuitive skill, foresight, initiative, perseverance, and intellectual power necessary to compel its success,” nevertheless, it must be remembered that it is always comparatively easy to see at hindsight the steps which might have been taken to avert failure. It must also be realized that many times the foresight which should be exercised to prevent failure is more than could reasonably be expected from most business men. Students of finance find themselves interested in studying the various problems which have caused failures and the remedies for them, since, if business men have been inefficient in meeting such problems successfully,

¹Dewing, A. S., *The Financial Policy of Corporations* (1934 ed.), page 1088

much can be learned through studying their mistakes.

A brief classification of the causes of business failures, which will form the basis of our discussion, follows:

1. Uneconomic or defective initial promotion.
2. Weak production or distribution policies.
3. Unwise dividend policy, and paying dividends from capital.
4. Overexpansion.
5. Cutthroat competition.
6. Poor financial planning
7. Unforeseen and severe economic readjustment, brought about by a sudden cessation of demand for the product, revolutionary or unusual legislation, wars, radical tariff changes, etc.
8. Operation of the business cycle.
9. Disasters such as earthquakes, fires, floods, and so forth.
10. Dishonesty and fraud.

A brief discussion of the various causes of failures listed above may be helpful.

1. *Uneconomic or defective initial promotion.*—Failures resulting from defects in initial promotion sometimes occur even years after a business has started. Railroads have been pushed into sections of a country years before the traffic of that country could afford sufficient revenue to pay operating expenses. During the period from 1900 to 1914, hundreds of small electric interurban railways were built through the northeastern part of the United States; most of these have disappeared today. Many of them were virtually failures from the outset. Day by day we find examples of promotions which have misjudged public taste and demand. It is not to be implied here that there is any sure way to forecast the success of a business which is being promoted, but it is true that many failures would be avoided if a proper *discovery* were made in the early stages of promotion.

2. *Weak production or distribution policies.*—Businesses

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which should have succeeded often fail because of waste and inefficiency in production. Modern competition effects lower profit margins, and the result is that the greatest of efficiency must be shown in the field of production so that costs may be kept at a minimum. Great progress has been made in the field of production in recent years, especially with regard to increasing general efficiency. Cost accounting systems have been installed; these show costs with accuracy. Much can still be done in the way of proper planning and budgeting, for one of the largest sources of loss arises through the improper scheduling of production to meet demand and through heavy inventory losses which follow overproduction.

In the field of distribution, losses occur through ineffective and misdirected advertising policies and, sometimes, from too little advertising. With competitors constantly striving toward dominance in the market, no concern can afford to rest idly upon its laurels or general reputation, but must constantly keep its name and product before the public. Many style changes add nothing of intrinsic value to a product; however, wide-awake concerns make such changes in order to have something to talk about as they attempt to keep their product continually before the public. A concern's profits come from the sale of goods and from services; and since under ordinary conditions a large proportion of its expense is likely to be fixed in nature, the smallest decline in gross income may be disastrous. Concerns which are alert strive not only to retain old customers but also to broaden their markets into new territories.

3. *Unwise dividend policy, and paying dividends from capital.*—The income of industrial companies is often extremely variable. In the prosperous years it is usually prudent to set aside a certain amount of earnings to take care of the deficiencies of the lean years. This is especially important where capital has been derived from bonds with attendant fixed charges. Concerns contemplating expansion programs will also find it expedient to set aside funds in periods of prosperity, in order that funds may be available for expansion in periods of depression. At such a time building costs are cheaper; and, if mergers are contem-

plated, the existence of large cash reserves will help maintain the price of the company's securities. This arrangement places the corporation in a better position to trade its securities for those of the company it may wish to absorb. The cost of expansion is an important factor when the future welfare of the concern is being considered. The obligation of the directors of a corporation to the corporation itself ranks equally with their obligation to the stockholders; if the welfare of the corporation demands a conservative dividend policy, not only should the directors act for the best interests of the corporation but, in so doing, they protect the capital investment of the stockholders.

Payment of dividends out of capital often results through payment of dividends from unrealized profits. Payment of dividends from the paper profits shown by the enhanced value of investment trust portfolios was a practice followed by certain investment trusts in 1928 and 1929, with the result that, where such securities were not liquidated prior to the market recession in the fall of 1929, stockholders found their capital investment impaired not only through decline in the value of portfolios but also through disbursement of capital.

4. *Overexpansion.*—Overexpansion and unwise expansion may lead to serious financial difficulties. Concerns may expand without regard to their working capital position. In fact, the working capital position may be impaired through the investment of too large a proportion of the cash on hand in fixed assets. The ambition of the management to expand its business and achieve a dominating position often meets with failure because markets have not been developed to take care of the increased capacity. The larger the plant, the greater the overhead which must be met. Increasing the capacity of a plant is foolish if markets cannot immediately absorb the increased output. The desire to expand often leads to the buying up of plants of weak or failing competitors and requires considerable capital expenditure before they can be placed on a paying basis.

Expansion of any sort should be the result of a well-developed plan and should take place only when it appears that the profits of the expanding concern will be increased

or their present profits protected. With the advent of the radio, many concerns manufacturing electric equipment and some in entirely different lines entered the radio business. The majority of these were not equipped successfully to push this side line to success. Those concerns which achieved the greatest success were obliged practically to divorce the radio business from their other businesses and to spend prodigious sums in research and advertising to establish their products. One of the main reasons for the failure of many concerns to maintain and develop their new radio business was the fact that no definite plan was laid and no effort was made to look beyond the immediate opportunity for profit that the public interest in radio seemed to offer.

5. *Cutthroat competition.*—Ordinary competition should not be classed as a cause for failure, for it is one of the common problems that all business men have to meet. Occasionally, however, larger concerns having abundant resources have deliberately forced smaller concerns out of business by cutting prices far below cost. A splendid example of such a practice is found in the conditions prevailing in intercoastal shipping through the Panama Canal for several years following the close of the World War. A number of the weaker concerns, after operating at a loss for some time, gave up and were absorbed by their stronger competitors.

6. *Poor financial planning.*—A poorly balanced capital structure with so much borrowed capital that the margin of safety is continually low is always in danger of failure. A small decline in the volume of business may result in insufficient funds to pay fixed charges and may cause foreclosure by the bondholder. Poorly balanced capital structures may result from the lack of a proper financial plan at the time of promotion or may result from piecemeal financing at later dates. The fact that borrowed money may often be secured cheaply and thus give an opportunity to trade on the equity leads some business men to sacrifice safety in order to gain this advantage. The cardinal principle of successful financial planning dictates not only that

the capital be obtained as cheaply as possible but that it be obtained as cheaply as is consistent with safety.

7. *Unforeseen and severe economic readjustment.*—Very severe readjustment may be brought about by a change in demand or styles which may entail more expense than a business can afford. Henry Ford was forced to close his factory for many months when he found that the public demanded a car more up to date in style than his model T. The Ford Motor Company was so strong that it was able to finance the readjustment successfully; a weaker concern might have failed. Readjustments because of change in demand are frequent. Wagon or carriage manufacturers lost much of their business to tractor and automobile producers. Most of those who did survive have gone into the automobile or some similar business. Concerns which enter businesses where style is an important factor, such as clothing and businesses of a like nature, should be prepared to cope with this factor as one of the natural hazards of such businesses. But, in a business where style is not a principal factor, the complete falling off in demand for the product may result in the tragedy of failure. Things which have been in great demand for years have been almost entirely displaced by new inventions. The radio practically ruined the phonograph business, and it has brought hard times to the piano manufacturers. Woolen and cotton goods, which had achieved the status of staple products, suffered for a period after the World War because of prevailing styles in women's apparel.

It is not always convenient for a concern to make the change to another product. Often machinery adapted to one product must be entirely scrapped if that product is to be abandoned. Putting out a new product creates new marketing problems. Consumer goodwill must be built up all over again. Frequently after a few attempts in this direction the concern must be liquidated.

Legislation may definitely ruin a prosperous business. Radical tariff changes may injure not only an importing business but also a domestic concern dependent upon foreign supplies in the manufacture of its product. These are

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factors which are not natural hazards of a business and are, therefore, difficult to guard against.

8. *Operation of the business cycle.*—Business forecasting is not an exact science. We are unable to predict with certainty the height and the degree of the slope, or the depth of the valley of business prosperity or decline. We have observed that the state of business is not always the same, that periods of prosperity seem to alternate with periods of depression. We have learned from experience to know some of the signs which seem to indicate that business has reached a dangerous degree of prosperity, and we recognize some of the signs which point to recovery from periods of depression. Nevertheless, we have not been very successful in predicting exactly when a period of prosperity will end, or how greatly and for how long a period business will be depressed. The result is that business men are often caught unprepared and are unable to adjust their businesses to these severe economic changes in time to avoid losses. Prudent business men, however, are not discouraged over the lack of accuracy in business forecasting, but are always trying through the careful study of their own experiences and those of others to increase the accuracy of their forecasts.

9. *Disasters such as earthquakes, fires, floods, and so forth.*—While a business may usually obtain insurance to cover losses occasioned by disasters such as those outlined above, the insurance usually covers only the property loss. If the disaster has a severe effect on business conditions, the business may not be able to return for years to its former position. The Mississippi River floods in 1927 practically paralyzed many business activities in that district for a year or more because of the losses suffered by the community. Failures from these causes cannot well be charged to incompetence, for often in such instances even superhuman efforts would not be able to continue a business successfully.

10. *Dishonesty and frauds.*—Banks in particular suffer failure from fraud. The costly Bank of the United States failure in 1930 was brought about through fraudulent acts on the part of its management. Other businesses, too, suffer from such things as the sale of property to a corpora-

tion by its own directors at a price greatly in excess of its real value, or the fraudulent disbursement of unearned profits and the outright theft of funds and property by those interested. Again, such losses may be insured against in part by bonding employees. Often, however, where the theft is by someone high in office in the business, no bond has been obtained for such protection.

▼ **Reorganization.**—The term *reorganization* usually implies a change in the financial plan of the corporation which is in financial difficulties. In the case of a railroad reorganization, this change is usually one which results in a reduction of fixed charges, for that is usually the chief problem of adjustment. In industrials, the obtaining of new money is the serious problem; and the reorganization may leave the industrial corporation with heavier fixed charges than before, or may leave it with an issue of preferred stock although at the time of its financial embarrassment the corporation may have had neither bonds nor preferred stock.

In addition to the change in the financial plan, the reorganization seeks to remove or overcome the cause of failure. This may result in the abrogation of leases, the sale of unprofitable property, or the replacement of an inefficient management with a better one. Often all of these things must be accomplished before any new money can be obtained. Reorganizations fall into three general types: (1) *reorganization with the help of the equity courts*, (2) *reorganization by a creditors' committee*, and (3) *reorganization under the Federal bankruptcy statutes*.

Equity receivership.—Whenever there exists a need for uninterrupted operation, as in the case of railroads or public utilities, or where there are many large conflicting claims, reorganization may be accomplished through *an equity receivership*. The court is brought into the reorganization through a creditor's petition for the appointment of a receiver. Frequently the creditor's action is a friendly one. In other words, the management, knowing that the financial embarrassment of the company cannot be remedied without such drastic action, prepares for the receivership and pre-

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vails upon a friendly creditor to start the proceedings. Sometimes a receivership of a railroad owing millions of dollars in interest is begun by a creditor to whom a sum slightly more than \$3,000 is owed. (\$3,000 is the minimum required to give a case federal court jurisdiction.) Very often in the case of railroad receiverships, the creditor requests that the president of the railroad be appointed a receiver. This is usually agreed to by the court though, because of the public interest involved, a wellknown lawyer may be appointed to act with him. The receiver, as an officer of the court, takes charge of the property and administers it for the benefit of all concerned.

The receiver appointed by a court of equity has the power to cancel contracts and abrogate leases; and the court may examine with great care the validity of the creditors' claims. Once the court has assumed control, the creditors must all submit to its jurisdiction, and the business is given a breathing spell in which to adjust its affairs.

General procedure in equity reorganization.—Detailed treatment of the complicated procedure of reorganization under an equity receiver is beyond the province of this chapter. In general, the steps may be summed up as follows:

1. Appointment of a receiver in equity.
2. Formation of *protective committees* by leading stockholders and creditors.
3. Deposit with a trustee of securities and claims giving the protective committees authority to act for the claimants they represent.
4. Selection by protective committees of representatives to form a *reorganization committee*.
5. Examination and appraisal of the property both as a basis for the court to set an upset price and also as a basis for the reorganization plan.
6. Drawing up the reorganization plan and naming of the reorganization managers, and submission of the plan for the approval of the protective committees, bankers, and other interested parties.
7. Making of an underwriting agreement—when the plan

has been found satisfactory—with the bankers to insure the obtaining of the new capital desired.

8. Submission of the reorganization plan and agreement to all the claimants with the request that claims and securities be redeposited with the trustees, who shall then have the authority to carry out the reorganization.

9. Newspaper and mail campaign to obtain consent to the plan of as many security holders and claimants as possible.

10. Incorporation of a new company to purchase the business and property.

11. Foreclosure by the trustees of the defaulted security, and cash settlement with those not participating in the reorganization.

12. Issue of new securities and collection of assessments; also, exchanging of the new securities for the securities of the old corporation.

13. Establishment of a voting trust to insure an uninterrupted management during the period of convalescence of the reorganized company.

A brief discussion of some of the foregoing steps may be helpful.

Often prior to the appointment of a receiver, the influential stockholders and the bankers who have floated the corporation's securities, knowing that the corporation is in difficulties, will voluntarily form *protective committees* to represent the various classes of claimants. Generally there is a protective committee for each class of claimant. These protective committees are frequently formed at the instance of the management to forestall possible opposition. Of course, there is no obligation on the part of a security holder to deposit his claims with the protective committee, but a vigorous campaign is usually conducted so that the majority will deposit. Sometimes *opposition committees* are formed, and they formulate their own plan of reorganization. If the opposition is strong enough, they may force a modification of the plan of the first committees. This happened in the recent reorganization of the Chicago, Milwaukee & St. Paul Railroad.

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Once the *reorganization committee* has approved a plan, it is submitted to all the claimants for approval; and if most of the claimants and security holders approve, the reorganization is carried out. A foreclosure sale is held, and a new corporation formed by the reorganization manager bids on the property at the upset price set by the court. There is usually one bidder—the new corporation formed by the reorganization manager. All the claimants then, according to the terms in the reorganization, receive securities in the new corporation in exchange for their old securities. Those holding the best claims, such as first mortgage bondholders, usually receive equally good securities in the reorganized company. Junior bondholders may receive income bonds or preferred stock or may have the principal sum cut down. Stockholders who have no equity left are forced to pay assessments if they wish to participate. A schedule showing the results of the reorganization plan of the Missouri, Kansas & Texas Railway Company is reproduced on page 409.

Reorganization by creditors' committee.—Sometimes, especially in the case of industrial concerns, the principal *creditors* voluntarily form a *committee* for the purpose of taking the necessary steps to protect themselves. This may lead to their taking actual charge of the business. Banks frequently have a so-called *financial* doctor or expert in their employ who is sent in to reorganize the business and to rehabilitate it. He is usually made an officer of the embarrassed concern and not only acquaints himself with the routine details of managing the business but also acts as a trustee of the receipts for the creditors.

In a creditors' committee reorganization, it is often difficult to get the unanimity of action possessed by a receiver. The creditors' committee, however, has several advantages. The publicity of an equity receivership is often fatal to an industrial concern. This point is illustrated by the fact that practically all attempts at industrial reorganizations under equity procedure result either in bankruptcy proceedings or in the taking over of the business of the embarrassed concern by a new corporation of an entirely different name. A creditors' committee, on the other hand, receives little pub-

REORGANIZATION PLAN OF THE MISSOURI, KANSAS & TEXAS RAILWAY COMPANY

WILL RECEIVE

(For Each \$1,000 Principal Amount of Existing Securities)

Amount	Description	Cash	Prior Lien Series		Prior Lien Series		Cum. Adj. Series A 5s	Pfd. Stock Series		Common Stock (Number of shares)
			A 5s	B 4s	C 6s	A				
\$39,999,500	M., K. & T. 1st Mtg. 4s, 1990	\$23.33	\$500	\$500	—	—	\$1,192.50	\$64.16	—	
20,000,000	M., K. & T. 2d Mtg. 4s, 1990	—	—	—	—	—	503.33	—	—	
9,992,000	M., K. & T. 1st & Ref. 4s, 2004	—	250	—	—	—	73.13	719.37	—	
10,421,000	M., K. & T. Gen. Mtg. 4 1/2s, 1936	—	250	—	—	—	525	525	—	
18,974,000	M., K. & T. Secured 6% Notes, 1916	—	350	—	—	—	500	666.67	1	
3,253,000	M., K. & T. 1st Mtg. Extn. 5s, 1944	—	—	—	—	—	250	750	2 1/2	
1,924,000	M., K. & T. St. L. Div. 1st Mtg. Ref. 4s, 2001	—	—	—	—	—	—	—	—	
2,500,000	Kan. City & Pac. 1st Mtg. 4s, 1990	36.67	500	500	—	—	—	—	—	
5,468,000	M., K. & Okla. 1st Mtg. 5s, 1942	33.33	1000	—	—	—	537.50	—	—	
4,000,000	M., K. & East 1st Mtg. 5s, 1942	—	750	—	—	—	500	656.25	9	
58,000	M., K. & East 2d Mtg. 5s, 1942	—	—	—	—	—	541.67	—	—	
4,550,000	M., K. & T. of Texas 1st Mtg. 5s, 1942	—	750	—	—	—	—	—	—	
1,340,000	Dallas & Waco 1st Mtg. 5s, 1940	33.33	1000	—	—	—	—	—	—	
2,098,000	Wichita Falls & N. W. 1st Mtg. 5s, 1939	—	1200	—	—	—	—	—	—	
838,000	Wichita Falls & N. W. 1st Lien Coll. Tr. 5s, 1925	—	500	—	—	—	675	—	—	
3,000,000	Wichita Falls & N. W. 1st Ref. Mtg. 5s, 1940	—	250	—	—	—	812.50	187.50	—	
743,000	Southwestern Coal & Imp. 1st Mtg. Tr. 6s, 1929	—	500	—	—	—	890	—	—	
883,000	Boonville R. R. Bridge 1st Mtg. 4s, 1951	26.67	—	1000	—	—	—	—	—	
13,000,000	M., K. & T. Pfd. Stk. (10 shares), on payment of \$20 a share	—	—	—	—	—	—	—	—	
63,283,257	M., K. & T. Com Stk. (10 shares), on payment of \$25 a share	—	—	—	—	—	60	—	10	

Note—The amounts of existing securities stated were the amounts outstanding in the hands of the public.³

³ Taken from "Individual Reports Section," Standard Corporation Records, Vol. 8, No. 1222.

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licity. Proceedings under the latter plan are likely to be less expensive because of the absence of legal procedure. In spite of these advantages it is unlikely that the use of creditors' committees will increase. It is almost impossible to obtain complete agreement among the creditors; and, since those creditors who do not agree must be bought off by the participating creditors, the plan encourages the creation of an undesirable *nuisance value* to the claims. The difficulty of avoiding litigation brought by dissatisfied creditors or by the management which has been ousted is another factor to be considered. This method of reorganization is probably most valuable in cases when one or two banks are the chief creditors and can engage in the transactions with practically no interference on the part of others.

Reorganization amendments.—Prior to the reorganization amendments of the United States Bankruptcy Act, the reorganization of corporations involved a cumbersome and awkward process of liquidation through judicial sale. Minorities impeded successful reorganizations by holding out for cash settlements. The need for court sanction and enforcement of plans designed primarily to extricate corporations from their difficulty became more pressing as severe depression increased the number of corporate failures and reorganizations.

Congress, by the statute of March 3, 1933, adding Section 77 to the Bankruptcy Act, provided for the reorganization of railroads employed in interstate commerce. By act of June 7, 1934, it added Sections 77A and 77B to cover, respectively, the reorganization of all railroads not eligible under Section 77 and every corporation that could become a bankrupt under the original Act.

Industrial reorganizations.—By an act approved June 22, 1938, and effective three months from the date of its approval, Sections 77A and 77B governing the reorganization of intra-state railroads, business corporations and public utilities were amended and incorporated as Chapter Ten, entitled "Corporate Reorganizations."

Petition.—A petition proposing that a plan of reorganization be effected may be presented by the corporation, or by three or more creditors having claims of at least \$5,000. The

petition may also be filed by a trustee under a mortgage or deed of trust, under which outstanding securities constitute claims against the debtor or his property. In a pending bankruptcy proceeding the filing may take place either before or after adjudication.

Every petition for reorganization must state the following facts:

1. A statement that the corporation is insolvent or unable to pay its debts as they mature.
2. Nature of business.
3. Assets, liabilities, capital stock and financial condition.
4. All pending proceedings affecting the corporation and the courts in which they are pending.
5. Status of any plan of reorganization or liquidation pending that affects the corporation, whether or not involving the courts.
6. Specific facts showing the need for relief and evidence to indicate why adequate relief could not be obtained by some arrangement or plan for the settlement, satisfaction or extension of the debtor's unsecured obligations, as provided in Chapter XI of the amended law.
7. Desire of petitioners that some plan of reorganization be effected.

If the petition is filed by creditors or by an indenture trustee, the following additional information must be shown:

1. Corporation has been adjudged a bankrupt in a pending proceeding; or
2. A receiver or trustee has been appointed or has taken charge of at least a major part of the corporate property in a pending equity proceeding; or
3. An indenture trustee or mortgagee is, by reason of default, in possession of at least a major part of the corporate property; or
4. A proceeding to foreclose a mortgage or to enforce a lien against the major part of the corporate property is pending; or
5. A corporation has committed an act of bankruptcy within four months before the filing of the petition.

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Approval of petition.—Upon the filing of a petition by creditors or by an indenture trustee, a copy of the petition is sent the debtor together with a subpoena returnable in ten days, or within a longer time if the court elects. If the debtor fails to answer or his answer does not controvert any material allegation of the petition, the judge, without the intervention of a jury, will enter an order approving the petition.

Approval is usually granted, whether the petition be filed by the debtor corporation or others, only if the judge is convinced of good faith and full compliance with the legal requirements. A petition is deemed not to be filed in good faith under any of the following circumstances:

1. Petitioning creditors acquired claims merely to qualify as petitioners.

2. Adequate relief may be obtained by some arrangement or plan for the settlement, satisfaction or extension of the debtor's unsecured obligations as provided in Chapter XI of the amended law.

3. No reasonable expectancy that a plan of reorganization can be effected.

4. A prior proceeding better suited to the interests of creditors and stockholders is pending.

Possession of property.—Upon the approval of a petition, the judge must appoint one or more disinterested persons as trustees, provided the debtor's obligations amount to \$250,000 or more. If the indebtedness is less than \$250,000, the judge has the option of continuing the debtor in possession or of appointing one or more disinterested persons as trustees. In any case where a trustee is appointed the judge may name as an additional trustee a director, officer or employee of the debtor.

Hearings.—In not less than thirty days and not more than sixty days after the approval of the petition, hearings are held at which objections to continuance of the debtor in possession or of the qualifications of the trustees may be voiced. Thirty days' notice of the hearing must be given by mail to creditors, stockholders, indenture trustees, the Securities and Exchange Commission and any other persons the

judge may designate. The notice may also be published in newspapers of general circulation, if the judge so desires.

Schedules filed by debtor or trustee.—Upon the approval of a petition, the debtor who is continued in possession must submit the following information under oath to the court at the time designated by that court:

1. Schedule showing the location, quantity and value of the property.

2. A schedule of the creditors of each class with the amount and character of the claims and securities and, if available, the post-office address or place of business of each creditor.

3. A schedule of stockholders showing their holdings of each class and their last known post-office or business addresses.

In the event that the debtor is not continued in possession, the trustee must file the last two of these schedules. The information thus submitted by debtor or trustee is in lieu of the schedules which a bankrupt files under the general provisions of the original Bankruptcy Act.

Duties of trustee or examiner.—Upon his appointment and qualification, the trustee may be called upon to perform the following duties under the direction of the judge:

1. Investigate and report to the judge upon the conduct, property, liability and financial condition of the debtor and the desirability of continuing the reorganized business.

2. Examine the directors and officers of the debtor and any other witnesses regarding all matters relating to a plan of reorganization.

3. Report to the judge any evidence of fraud, mismanagement or other irregularities.

4. Employ any assistants in this work, subject to the approval of the judge.

5. Submit at the earliest possible time a complete report of his findings, in the form designated by the judge, to creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and other interested persons.

6. Notify creditors and stockholders that they may submit

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to him actual reorganization plans or suggestions within the time designated in the notice.

If the debtor is continued in possession, the judge may appoint a disinterested person as examiner to perform any of the first five of these duties.

Operation during reorganization.—Upon authorization by the judge, a trustee or the debtor in possession must operate the business and manage the property for such a limited or indefinite period as the judge may from time to time stipulate. During this period reports must be filed with the court at designated intervals.

Plan of reorganization.—Where a debtor is continued in possession, plans of reorganization may be filed by any of the following within the time limit specified by the judge:

1. Debtor.
2. Any creditor.
3. Indenture trustee.
4. Any stockholder, if debtor is solvent.
5. Examiner, if so directed by judge.

If a trustee is in possession, he must submit the reorganization plan, or his reason why he cannot, in the time designated by the judge.

After a hearing on proposed plans, the judge may, if the scheduled indebtedness does not exceed \$3,000,000, submit to the Securities and Exchange Commission any plans which he regards as worthy of consideration. If the scheduled debt exceeds \$3,000,000, he must do so. The judge will not order the approval of any plan submitted to the Securities and Exchange Commission until that body has either filed its report thereon or declined to do so in the time designated for reporting. Upon approval of a reorganization plan by the judge, it is the duty of the trustee or debtor in possession to transmit the details of the plan, the judge's opinion, the report, if prepared, of the Securities and Exchange Commission, and other pertinent information to all interested creditors and stockholders.

Acceptance by claimants.—To become operative, the reorganization plan must first receive the approval of two-

thirds in amount of each class of creditors whose claims have been allowed. If the corporation has an excess of assets over liabilities and the reorganization is merely to correct the company's inability to meet debts as they mature, the reorganization must also be approved by the majority of each class of stockholders affected.

The approval of the following classes of claimants is unnecessary:

1. Creditors and stockholders unaffected by the plan.
2. Claims appraised and paid-off in cash.
3. Creditors and stockholders disqualified for bad faith in accepting or failing to accept a plan.
4. Claimants receiving proceeds from sale of property at not less than upset price.
5. Claims equitably protected in any other manner.
6. Stockholders if the corporation is insolvent.

The judge's order approving a plan does not affect the right of the debtor, creditor, indenture trustee or stockholder to object to the confirmation of the plan.

Provisions of reorganization plan.—The reorganization plan must contain the following provisions:

1. Modification or alteration of the rights of creditors or stockholders generally or any classes of them.
2. Payment of all administration costs and expenses and other allowances approved by the judge.
3. List, if any, of claims which are to receive full cash payment.
4. List of creditors and stockholders not affected by plan.
5. Equitable and fair treatment of any class of affected creditors which does not accept the plan by the required two-thirds majority in amount.
6. Adequate protection, where the corporation is solvent, for stockholders.
7. Adequate means for execution of plan, which may include retention of property by debtor; transfer of any or all of the debtor's property to one or more corporations organized previously or thereafter; merger or consolidation of the debtor with other corporations; sale of property at not less

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than upset price and disposal of proceeds or of the assets themselves among those having any interest therein; modification of liens; curing or waiver of defaults; extension of maturity dates; change in interest rates or other terms of outstanding securities; amendment of debtor's charter; and issuance of new securities to satisfy existing claims or raise additional cash.

As safeguards to security holders, the charter of the reorganized company must prohibit the issuance of non-voting stocks and must provide for equitable distribution of voting power among voting classes of stock. As regards preferred stockholders with preference as to dividends, the charter must carry adequate provision for election of directors when dividends are in default. Where the indebtedness is at least \$250,000, the charter must also require financial reports, including balance sheets and income statements, to be issued to security holders at least annually.

In addition to these provisions, the reorganization plan may also include any other provisions deemed consistent or expedient for the success of the reorganization. The plan may, for example, provide for the rejection of any executory contract except contracts with public authorities. Where any indebtedness is created or extended under the reorganization plan for a period of more than five years, the plan will provide for the retirement of the debt by stated or determinable payments out of a sinking fund or otherwise. These payments may continue through the expected useful life of the security, if the debt is secured. If the obligation is unsecured or if the life of the security is not fairly ascertainable, the debt must be retired within a reasonable time, not exceeding forty years.

Confirmation of plan.—After the judge has heard all objections to the reorganization plan, he will confirm it if satisfied that it is fair and feasible and that it has met all requirements of the statute. One of the prerequisites to judicial approval is the disclosure of all amounts to be paid by the debtor or by the corporation formed to take over the assets, and of all amounts paid to committees or managers for services rendered in the reorganization. These payments

must be reasonable in amount and are subject to the approval of the judge.

The identity, qualifications and affiliations of the persons who are to be directors, officers or voting trustees upon consummation of the plan must also be disclosed. Their appointment or continuance in the office must be equitable, compatible with the interests of creditors and stockholders and consistent with public policy.

Modification of plan.—Changes in the reorganization plan may be proposed, either before or after the plan is confirmed, and may be approved by the judge after a hearing. Any creditor or stockholder who has previously accepted the plan proposed to be altered and who does not file a written rejection of the modification is deemed to have accepted the modification, unless the previous acceptance otherwise provides.

Execution of plan.—Upon judicial confirmation of the plan, the old corporation or the corporation organized to take its place has complete authority to put the plan into effect. The court directs the trustees, if any have been appointed, or the old corporation to convey the property to the new corporation, if one has been organized. A final decree is then entered by the judge discharging the trustees, releasing the corporation from all debts, and terminating all rights of stockholders except as provided in the plan.

Reorganization of public utility corporations.—Reorganization procedure as outlined in the previous section applies to any industrial corporation and to any intra-state railroad not covered by Section 77 of the Act. It also applies to public utility corporations with slight modifications as respects public utility commissions having regulatory jurisdiction.

When the corporation being reorganized is a public utility company subject to the jurisdiction of a public utility commission, an opportunity must be granted to the commission to suggest objections and amendments and to be heard by the judge before the plan is confirmed. If the public utility is wholly intra-state, no plan can be approved until the state commission has first certified its approval of the plan. The

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commission will approve only if the plan in its opinion is fair and serves the public interest.

Arrangements.—Chapter XI of the amended Bankruptcy Act covers arrangements for which a debtor corporation must petition if relief can be obtained by some agreement with his unsecured creditors. As before mentioned, a debtor can petition for reorganization under Chapter X as described in preceding sections, only if so seriously involved as to require modification of the rights of security holders and stockholders for correction of his difficulties.

An arrangement means any plan of a debtor for the settlement, satisfaction or extension of the time of payment of his unsecured debts.

Petition.—A debtor may file a petition for an arrangement in a pending bankruptcy proceeding either before or after his adjudication. The petition must state that the debtor is insolvent or unable to pay his debts as they mature and must set forth the provisions of the arrangement which he proposes. The debtor must submit a statement of his executory contracts, statement of affairs, schedules of claims and the required fees with the petition.

A petition may include any of the following provisions:

1. Treatment of unsecured debts on a parity with one another.
2. Division of debts into classes and the treatment of the various classes upon different terms.
3. Rejection of any executory contract.
4. Payments on account during a specified period of extension.
5. Conditions under which an arrangement may be terminated.
6. Continuation of the debtor's business with or without supervision by a receiver, committee of creditors, or otherwise.
7. Priority of debts incurred after filing of petition and during pendency of arrangement.
8. Retention of jurisdiction by the court until after the arrangement has been confirmed and its provisions performed.
9. Any other pertinent matters.

Confirmation of arrangement.—An arrangement unanimously accepted in writing by creditors will be confirmed by the court when the debtor has made the required deposit, provided the court feels that the arrangement and its acceptance are made in good faith. If an arrangement has not been unanimously accepted, an application for its confirmation may be filed with the court only after a majority in number of all creditors representing a majority in amount of claims have indicated their acceptance in writing. If creditors are divided into classes, the majority in number of creditors and amount of claims for each class must give written approval. In either case only creditors who are affected by the arrangement and whose claims have been allowed before the conclusion of the meeting are counted.

Upon confirmation of the arrangement, the debtor is discharged from all his unsecured debts and liabilities except non-dischargeable debts. Examples of debts not affected by a discharge are taxes and wages earned by employees within three months from the commencement of the proceedings.

The moneys deposited for priority debts and for costs and expenses are first distributed. The consideration, if any is deposited, is then distributed and the rights provided by the plan inure to creditors whose claims have been proved and allowed or have been scheduled by the debtor as fixed obligations and not disputed.

Reorganization of railroads.—Section 77 of the amended Bankruptcy Act makes special provision for the reorganization of railroads employed in interstate commerce. Though this appears in an earlier chapter² of the Act than corporate reorganizations, the order is here revised to permit a summary treatment of railroad reorganizations.

In their general features, the provisions for interstate railroad reorganization correspond to those already outlined for reorganizations of industrial corporations. The essential difference is the fact that railroads are subject to the regulation of the Interstate Commerce Commission, which plays an important role in railroad reorganization proceedings.

The distinctive features between railroad reorganizations

²Chapter VIII of the United States Bankruptcy Act, Prentice-Hall Bankruptcy Service.

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under Section 77 and corporate reorganizations under Chapter X may be briefly summarized as follows:

1. A copy of the petition, whether presented by the railroad or by creditors, must be filed with the Interstate Commerce Commission.

2. A petition may be filed by creditors having claims totaling five percent of the railroad's total debt, if a petition has not already been filed by the railroad.

3. Unlike other corporate reorganizations, the property cannot be left in the possession of the corporation. The appointment of a trustee or trustees by the judge to take title to railroad property is mandatory and each appointment must be ratified by the Interstate Commerce Commission.

4. Before a court may confirm a reorganization plan, approval by the Commission is essential. A plan may be proposed by the railroad, by trustees, or by creditors or stockholders constituting ten percent or more in amount of any class. With the consent of the Interstate Commerce Commission, a plan may be filed by anyone else having an interest in the reorganization.

5. When approved by the court, the plan is submitted by the Commission to creditors and stockholders for approval.

6. Approval of the plan by creditors and stockholders requires a two-thirds vote of each class. The Commission determines whether the approval of the plan by any class of creditors or stockholders is necessary, but its findings must be affirmed by the court.

7. If satisfied that a plan of reorganization is fair to those rejecting it, the court may confirm the plan even without the required percentage of approval.

8. The Commission, wherever necessary, determines the value of the railroad property.

✓ **General objects to be accomplished by reorganization.**—As has already been indicated, the objects to be accomplished by reorganization will depend upon the type of business, whether it be a railroad, a public utility, or an industrial. Also, there are always specific objectives in each case which are peculiar to the situation. Generally, however,

the main objectives of reorganization may be summarized as follows:

1. The reduction of the current debt accomplished by funding, by the obtaining of new money through assessments of the stockholders, or by the outright sacrifice on the part of the creditors of a part of the principal sum due them.

2. The reduction of fixed charges through the substitution of income bonds or preferred stock for a fixed interest-bearing debt; the scaling down of part of the debt or the reduction in the amount of interest.

3. The promise of new money for working capital, obtained through assessments of the stockholders.

4. The disposal of unprofitable properties. This is usually done by the receiver under the direction of the court.

5. The providing of a new management. This step will, of course, depend upon the circumstances of the failure—that is, whether the causes are clearly attributable to mistakes of the old management.

Failure and liquidation.—If reorganization is undesirable or impossible, it is necessary to *liquidate* the business for the payment of debts. Liquidation may take place without bankruptcy through an arrangement with the creditors whereby each agrees to settle for a certain amount of his claims. If a large number of creditors (not necessarily all) agree to the same terms of settlement and sign a mutual agreement to discharge the debtor upon his complying with such terms, a common-law composition is effected and is binding upon those who sign. Unless, however, such an arrangement can be made practically unanimous as far as the creditors are concerned, it is usually abandoned. Creditors not joining may file a petition in bankruptcy at any time, or may attach a nuisance value to their claims in an endeavor to force the other creditors to buy them off.

An old method of settlement was to make an assignment for the benefit of the creditors. That is, the debtor would assign his assets to a trustee to be sold or otherwise disposed of for the payment of his debts. Since the debtor is not discharged of his debts by this procedure, and because the assignment is in itself an act of bankruptcy, this

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method is seldom used. Modern bankruptcy procedure accomplishes the same purpose through the appointment of a receiver or trustee in bankruptcy and has the added advantage that the debtor may be legally discharged of his debts by the court.

Bankruptcy.—Bankruptcy actions are brought under the federal law. Any person except a municipal, railroad, insurance, or banking corporation or a building and loan association may become a voluntary bankrupt.

Any natural person, except a wage earner or farmer, and every business corporation, except a municipal, railroad, insurance or banking corporation may be adjudged an involuntary bankrupt, provided there is owing \$1,000 or over. A petition may be filed within four months after the commission of any one of six acts of bankruptcy.

The six acts of bankruptcy by a debtor are as follows:³

1. "Conveyed, transferred, concealed, removed, or permitted to be concealed or removed any part of his property, with intent to hinder, delay, or defraud his creditors or any of them; or

2. "Transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or

3. "Suffered or permitted, while insolvent, any creditor to obtain a lien upon any of his property through legal proceedings and not having vacated or discharged such lien within thirty days from the date thereof or at least five days before the date set for any sale or other disposition of such property; or

4. "Made a general assignment for the benefit of his creditors; or

5. "While insolvent or unable to pay his debts as they mature, procured, permitted, or suffered voluntarily or involuntarily the appointment of a receiver or trustee to take charge of his property; or

6. "Admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt."

Discharge in bankruptcy.—Under the amended Bankruptcy Act, the adjudication of any person except a corporation shall operate as an application for a discharge. A corporation may, within six months after its adjudication, file an application for a discharge in the court in which the proceedings are pending. He must have surrendered all his

³United States Bankruptcy Act, effective September 22, 1938, Chapter III, Section 3.

property to the custody of the receiver or trustee in compliance with the provisions of the Bankruptcy Act. Discharge by the court frees the debtor from the legal obligation of paying his debts. Creditors may oppose his discharge if they find that the bankrupt has not acted in good faith; i.e., committed some fraud, such as concealing his assets, etc.

Priority of claims.—The Bankruptcy Act specifies the order in which claims against the bankrupt estate shall be paid, as follows:⁴

1. "The actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the filing fees paid by creditors in involuntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, shall have been recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the costs and expenses of administration, including the trustee's expenses in opposing the bankrupt's discharge, the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the petitioning creditors in involuntary cases and to bankrupt in voluntary and involuntary cases, as the court may allow;

2. "Wages, not to exceed \$600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt;

3. "Where the confirmation of an arrangement or wage-earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under this Act, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence;

4. "Taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof: *Provided*, That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; *And provided further*, That, in case any question arises as to the amount or legality of any taxes, such question shall be heard and determined by the court, and

⁴ United States Bankruptcy Act, approved June 22, 1938, Chapter VII, Section 64.

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5. "Debts owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law; *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

6. "Debts contracted while a discharge is in force or after the confirmation of an arrangement shall, in the event of a revocation of the discharge or setting aside of the confirmation, have priority and be paid in full in advance of the payment of the debts which were provable in the bankruptcy or arrangement proceeding, as the case may be."

Legal aid required in bankruptcy.—Because of the technical legal nature of bankruptcy proceedings, attorneys should be engaged to represent both parties. Often one attorney will represent all the creditors, while the debtor will engage another attorney to represent his interests.

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Questions for Study and Review

1. Explain briefly ten causes of business failures.
2. What is meant by the term *reorganization* as applied to a corporation?
3. Distinguish between three general types of reorganization.

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4. List thirteen steps which outline the procedure of reorganization under an equity receiver.

5. Mention the advantages and limitations of creditors' committee reorganizations.

6. By whom may a reorganization plan be filed for an industrial corporation under the United States Bankruptcy Act?

7. What is necessary to make such a reorganization plan for an industrial corporation operative?

8. How does the reorganization procedure for public utility corporation differ from that for industrial corporations?

9. What is an arrangement under the United States Bankruptcy Act?

10. In what essentials does railroad reorganization under Section 77 differ from industrial reorganization procedure?

11. Mention the five main objectives of reorganization.

12. What are the six acts of bankruptcy?

13. How may a debtor obtain his discharge from bankruptcy and what is the effect?

14. What is the priority of claims against a bankrupt estate under the United States Bankruptcy Act?

Problems

1. The Shelbourne Machinery Corporation has been established and operated successfully for a number of years. During the past three years, however, weak and incompetent management has resulted in a series of difficulties which have caused the company steadily to lose money and become insolvent. Prospects for a reorganization are good and, with a change in management, the company should in two or three years get back on its feet. The balance sheet prior to the reorganization is as follows:

BALANCE SHEET (Prior to Reorganization)

ASSETS	LIABILITIES
Current Assets:	Current Liabilities:
Cash.....\$ 6,000	Notes Payable.....\$100,000
Notes Receivable..... 84,000	Accounts Payable..... 90,000
Accounts Receivable... 65,000	Accrued Wages, Taxes, etc..... 10,000
Inventories..... 36,000	
Total.....\$191,000	Total.....\$200,000

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Fixed Assets: Plant and Equipment.. 110,000 Deficit..... 59,000 TOTAL ASSETS..... <u><u>\$360,000</u></u>	Fixed Liabilities: 1st Mortgage 8% Bonds 20,000 Capital Stock: 6% Preferred Stock.. 100,000 Common Stock (\$100 par)..... 40,000 TOTAL LIABILITIES..... <u><u>\$360,000</u></u>
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A. You are to prepare a reorganization plan like that on page 409 together with a balance sheet giving effect to the reorganization.

The following changes in equities have been agreed upon by the creditors and the stockholders:

a. The first mortgage bondholders have agreed to accept in exchange for their present holdings 50 per cent in 6 per cent income bonds and 50 per cent in new common stock.

b. Notes payable (carried at 5 per cent interest rates) to banks are to be reduced 20 per cent; the new amount shall consist of 62½ per cent of 7 per cent prior preferred stock; and 37½ per cent shall be carried over by the new company as regular notes payable.

c. Accounts payable (non-interest bearing) are to be reduced 40 per cent; the new amount shall consist of 55½ per cent of 7 per cent prior preferred stock; and 44½ per cent shall be carried over by the new company as regular accounts payable.

d. The old 6 per cent preferred stock is to be exchanged par for par for new common stock which is to have the same par value as the old.

e. Common stockholders have agreed to subscribe at \$34 per share for new common stock to the extent of one share of new common for two shares of old.

f. \$15,000 worth of unused plant and equipment will be sold for \$10,000 cash, and the proceeds used for new working capital.

B. Assuming that potential earnings in two or three years may rise to a maximum of \$10,000, criticize the reorganization plan.

CHAPTER XXI

Financing of Real Estate

The business man's interest in real estate.—Practically all businesses require a definite location. The primary problems of the business man in connection with real estate are the following:

1. Choosing the proper location for his business.
2. Financing the acquisition of such a location.

The selection of a location is an important consideration. The average business man is not engaged in the real estate business and simply ventures into the real estate field in order to acquire a place in which to transact business. It is only after the first problem has been solved—finding a proper location—that the business man may approach his second problem, which is the financing of the actual acquisition of the property.

If the property is to be purchased, it must be financed to 100 per cent of the value or cost of the property. In other words, before the business man can become the owner of the real estate, he must see that the seller of the property receives its full value or the agreed price. As a matter of fact, the financing of a location includes, in addition to the acquisition of the ground itself, the cost of the buildings to be erected thereon. Of course, the business man may lease property; in this event he does not acquire its ownership but pays a rent to someone else who owns the property. Ordinarily, such rent will be sufficient to cover the taxes, interest on the mortgage, operating expenses, depreciation, and a fair rate of return on the equity in the property. Should the business man, on the other hand, determine to buy the property and thus become the owner, he would not have to pay rent to another person, but he would then be

faced with the problem of financing its purchase. He may do this, as will be shown later, by borrowing on mortgage, from various sources which are available, a fair part of the value of the property. However, he still has to finance by other means that part of the cost of the property over and above its borrowing capacity.

Selection of a proper location.—It is very important to determine the proper location of a business. The importance of the site may vary according to the type of business involved; but whether it is a store, a factory, or a warehouse, or whether it is the first or the thousandth unit, care should be exercised in selecting the location. In certain types of business, thought must be given to such considerations as railroad sidings, wharfage, and like facilities. In other types of business, the presence or lack of public utilities, such as gas, electricity, and water at cheap rates, may affect the decision. A great amount of business property is acquired for store purposes; in such businesses the value of location on one side of a street in comparison with the other, or nearness to the corner, the proximity of competitors, and the general character of the neighborhood are usually of vast importance. The choice of office locations may depend upon nearness to transportation facilities for the employees. Financial firms may wish to be near the Stock Exchange and other financial markets.

In the case of stores, an attempt is made to obtain some idea of the volume of business to be done in a certain location before the property is purchased or leased. One method of doing this is by an analysis of pedestrian traffic, which, in short, means that the number of persons who pass a location are counted, the character of this pedestrian traffic is noted, and on the basis of data collected from experience in similar locations, estimates are made as to the number of persons who will stop to buy and the average purchase that will be made by each.

In the choice of an industrial site, a business is chiefly concerned with four factors:

1. Availability of raw materials.
2. Labor supply.

3. Nearness to market.
4. Taxes.

1. *Availability of raw materials.*—Where the raw material is very bulky and presents transportation difficulties, it may be quite important from a cost point of view to place the plant near the source of supply. The location of steel and iron mills in this country has been due largely to the proximity of the fuel supply. The factor of power has led to the location of many factories near available water power so that the firms might benefit from the cheap electricity obtained thereby. Cotton mills have been gradually springing up all over the South partly on account of the proximity of raw materials. The location of paper plants and lumber mills in the vicinity of forests is a very common example of the way in which materials influence the location of a business.

2. *Labor supply.*—Labor is such an important factor in the manufacturing industry that the high cost of labor or the lack of an available supply presents a very serious problem to the manufacturer. Publishing houses, cotton mills, and other businesses have moved to the South because of labor problems with which they have to contend in northern locations. The standard of wages varies in different parts of the country, and concerns often locate in a certain section because the cost of labor is likely to be less there.

3. *Nearness to market.*—The problem of marketing naturally involves that of location, because of the cost of transporting manufactured goods from the factory to the consumer. A New York plant wishing to sell in the Middle West, in order to make up for the difference in transportation costs, would have to lower its prices to compete with a Chicago factory selling the same article. To facilitate the marketing of their products, factories often find it convenient to locate at railway centers or near navigable waters.

4. *Taxes.*—Manufacturing corporations have learned that local real estate taxes may become a serious burden on the business. More than one business concern has left a community on account of the high taxes. Others by threaten-

ing to move have obtained reduced assessments. Rates in the United States vary from about \$12 to \$75 per one thousand dollars of assessed value. It is estimated that from 10 per cent to 35 per cent of the gross income dollar is turned over to the Government in the form of taxes. Taxes are important.

The cost of real estate.—Fully as important as location is the cost of real estate. One location may be worth \$50,000 a year while another near by may not be worth \$5,000. Whether the business man buys or rents real estate, he must keep its cost within certain well recognized limits. If the property is owned, the combined expenses—namely, taxes, insurance, repairs, interest on mortgages, and a fair return on the equity—must not exceed a certain per cent of the volume of business which can be transacted in the location. If the property is leased, the rent should not exceed a certain per cent of sales. There can be no rigid formula as to what this percentage should be, since location and conditions will vary for each individual case. However, the following expert opinions of maximum rent percentages are offered for illustrative purposes:¹

<i>Type of Store</i>	<i>Percent</i>	<i>Type of Store</i>	<i>Percent</i>
Art goods, artists' supplies . . .	10	Furs	8-10
Art shops	10-12	Furniture	5-8
Auto accessories	8-10	Garage storage	40-50
Auto agencies	1½-2	Gas stations	1 cent per gal.
Bakeries	4-6	Grocery stores, ordinary . .	4-10
Barber shops	10-15	Grocery stores, chain	2½-7
Beauty shops—merchandise .	10	Haberdasheries	7½-10
Beauty shops—service	10-15	Hardware stores	5-10
Books and stationery	10-12	Hoisery and knit goods . . .	6-10
Books, second hand	15	Jewelry	8-12
Beer parlors	8	Jewelry, cheap costume . . .	12
Candy	7-15	Jewelry, exclusive	12-15
Cigars and tobacco	5-10	Meat markets	4-6
Department stores	3-5	Men's clothing	6-8
Drug stores	5-8	Men's furnishings	7-12
Drug stores, individual	8-10	Men's hats	6-10
Electrical goods	5-7	Men's shoes	6-10
Florists	8-15	Men's shoes, volume	5-6
Fruit stores	12-15	Men's wear	8-10

¹North, N. L., *Real Estate Selling and Leasing*, pp. 296-298.

<i>Type of Store</i>	<i>Percent</i>	<i>Type of Store</i>	<i>Percent</i>
Millinery	10-15	Sporting goods	5-8
Motion pictures	12	Theatres and hotels	8-10
Optical stores	10-12½	Trunks and leather goods .	8-10
Pianos and musical instr. .	6-8	Women's cloaks and suits.	6-10
Radios	6	Women's furnishings	6-8
Restaurants	5-12	Women's shoes	6-10
Cafeterias	5-9	Women's shoes, volume	5-7
Luncheonettes	10-12	5-10¢, or 25¢ to \$2.	5-8
Tea rooms	10	Retail stores (general average)	7
Specialty stores (non-advertising)	8-10		

Methods of financing the location.—Once a location has been chosen, there are, in general, two ways of acquiring it. It may either be bought or leased. The problem then arises as to which method is most expedient for the business concerned. To purchase requires capital, which must either be taken out of the business or obtained from outside sources. The leasing of property entails the payment of a rental to the owner. There are other matters, too, which complicate this decision. For example, many businesses follow the policy of purchasing real estate not only to gain a landlord's income for themselves but also to make any profit which may accrue in property values. Other businesses, applying the same reasoning, decide that it is a better policy not to own real estate, in order to eliminate any possible loss through shrinkage in value. Many businesses desire to avoid the responsibilities of real estate ownership. They prefer to lease property, thus avoiding the many problems of ownership and care in management that are a necessary adjunct to the possession of a number of properties.

Purchase of real estate.—The amount of real estate which a business enterprise should acquire and the methods of financing the purchase depend upon the policy of the company, its needs for property, its own financial resources, and available outside financial assistance.

Since the main purpose of the average business enterprise is not that of investing in real estate, the management normally adopts some policy designed to reduce this investment to a minimum. This objective may be attained by leasing, thereby evading the financing problem, or by depending

upon outside sources to furnish a substantial portion of the purchase price.

Methods of financing.—Real estate purchases may be financed by borrowing on a mortgage on the property or by selling an interest in the property in the form of a stock issue. Ordinarily, available surplus funds and the proceeds from the sale of stock should be used to acquire the site, if the earnings of the business fluctuate greatly. This use of owners' funds for the outright purchase of property thereby avoids the danger of loss through default and foreclosure.

Even when the enterprise is financially able to purchase property outright, it is often expedient to obtain part of the required funds by mortgaging the newly-acquired real property and to employ the company's surplus for expansion needs and in a manner that will net a greater return. Where owners' funds are not available, there is no alternative to borrowing.

The difference between the purchase price and the actual money provided by the business itself may be provided as follows:

1. Temporary loans.
2. Long-term debenture loans.
3. First mortgage loans.
4. Junior mortgage loans.
5. Purchase money mortgage loans.
6. Building or construction mortgage loans.
7. Installment mortgage loans.
8. Trust mortgage loans.
9. Participating mortgage loans.

Temporary loans are theoretically unsound and always dangerous for financing the acquisition of fixed assets. Debenture loans are usually available only for strongly-financed companies. The great preponderance of loans on real estate are secured by the various types of mortgages.

First mortgage loans are secured by a first lien on the property covered. Because of priority of claim, first mortgages are a popular investment medium for trust funds, banks and most lending institutions. Hence the financing cost to the borrower is relatively low under normal conditions

for this type of loan. Where the property is already encumbered or the owner desires it free from encumbrance for future financing, some other form of mortgage loan may be necessary.

Junior mortgage loans are secured by subordinate liens on property. Because of the risk attending junior liens, junior mortgages generally involve high financing costs and are employed when other types of loans are not available.

Purchase money mortgages are given to secure a part of the purchase price of property and accompany the transfer of ownership. They may be first mortgages when the property purchased is not subject to existing mortgages. Purchase money mortgages may be given back to the sellers or made to third parties who advance part of the consideration for the sale of the property.

Building or construction loan mortgages are made for the purpose of financing the construction of buildings. These loans are advanced in installments as the construction progresses. While the true building loan mortgage is payable as soon as the building is completed, a combination building and permanent loan is available for those who desire to extend the term of the loan beyond the time the building is completed. The time is extended for a definite period, usually several years.

Installment mortgages provide for repayment of the principal sum loaned in installments over a period of time. In this respect they differ from permanent mortgages where nothing except interest is payable until maturity. Where the periodic installment is small and continues over a long period of time, installment mortgages are often designated as amortizing mortgages. They are sometimes called pay-down mortgages, however, where installments run for a few years and represent a substantial portion of the mortgage.

A trust mortgage is made to a trustee who acts on behalf of the various holders of the bonds issued under the indenture. The trustee collects interest, supervises the loan and collects the principal as the mortgage matures. In states where default procedure under an ordinary mortgage is cumbersome, trust deeds are employed in place of trust mortgages.

Participating mortgages are those in which two or more persons have specified interests. If there are numerous shareholders, one corporation or individual may act as trustee. Where there are only a few shareholders, one will often collect and distribute interest on behalf of the others. The indenture may provide for equality of interest or may be split into senior and junior shares. In the latter case the senior shareholders are first entitled to collect both principal and interest to the extent of their rights before junior shareholders are entitled to anything.

Subsidiary real estate corporation.—It is well to bear in mind that many businesses, as a matter of policy and convenience, do not acquire title in the business name but form a subsidiary corporation for that purpose. To illustrate, chain store corporations in order to obtain desirable sites without too great a burden of rent often acquire sufficient property to house the store and erect on the property an office building which will be rented to concerns desiring office space. A large Eastern chain store corporation controls a real estate subsidiary which owned over 125 parcels of city property having, as shown by a recent balance sheet, a cost value of \$23,762,657. The peculiar problems surrounding the management of huge real properties of this kind are handled more efficiently if a separate organization is maintained for the purpose. The financing of the real estate and the liabilities in connection with its acquisition are such that it is often deemed better business practice to keep them apart from the regular business of the concern. For instance, it may be necessary in acquiring a certain location to buy other parcels of land not desired by the business for its immediate needs but which may prove valuable later for trading purposes. Thus a desired site which has been divided up into several lots and owned by different parties may be assembled through a series of separate trades and deals.

Sources of mortgage loans.—Mortgage loans are obtainable from many sources. The life insurance companies which have vast sums to invest take many mortgages upon real estate. The return is good; and if the mortgage is well within the borrowing capacity of the property, reason-

able safety is assured. In this matter of safety, savings banks find mortgages one of the most desirable forms of investment. Moreover, first mortgages are proper investments for trustees, and large trust companies invest in this way great sums of money for which they are trustees. Building and loan associations, mortgage companies, title companies, land banks, and farm loan associations are engaged primarily in the business of financing real estate. Some of the large lending institutions make mortgage loans on huge properties, and then sell participating shares or certificates to the investing public. Finally, many mortgage loans are obtained directly from individuals who have funds to invest; such loans are placed by the individuals directly or through the medium of a broker, a bank, or a mortgage company.

The borrowing capacity of the property.—In the preceding discussion, use has been made of the term *borrowing capacity of the property*. No exact definition of this phrase is possible. The term relates to the amount which can with safety be borrowed on a piece of property. Under the law in New York, savings banks may lend up to 60 per cent of the value of improved property and 40 per cent on unimproved and unproductive property. Many lenders feel that this is a rather safe rule to follow. There are circumstances which may alter the situation. If the property is located in a rapidly growing community, a lender may feel safer in lending a higher percentage of the then appraised value than he would if the property were in a section not so likely to enjoy the benefits of growth and activity. We have only to recall the overextension of loans which usually takes place prior to a business depression to realize that mistakes are often made and that lenders lose through too high an appraisal of property values.

The character of the building with regard to utility is a factor which must always be considered for mortgage loan purposes. This point involves two considerations. In the first place, can the building, without excessive expense, be used for any other purpose, or must it always be used for the same purpose for which it was originally constructed?

If it can be used for only one purpose, then the lender must always keep in mind the fact that, in the event of foreclosure, his market for the building is greatly restricted, because the building is susceptible of ready sale only to a purchaser in that one line of business or for lease to a tenant in that single line of business. The second consideration is whether the community is overbuilt with that particular type of building. This last point is very well illustrated by public garages and theatres. Both of these types of buildings are restricted to only one use. While they are good security for mortgage loans if there are no more of them in the community than are sufficient to serve its needs, they would be very poor security for a mortgage loan if there were too many of them.

Illustrative financial plans.—Two financial plans are given to illustrate the considerations involved in computing the net return on an office building as well as to show the effects of successive reductions in earnings. The investment value is assumed to be \$1,500,000, as follows:

Land.....	\$ 600,000.
Building Construction.....	800,000.
Organization expense.....	100,000.
	<u>\$1,500,000.</u>

Under the first plan fifty per cent of the cost is borrowed on a first mortgage, as compared to sixty-six and two-thirds per cent under the second plan.

PLAN NO. ONE

Sources of Funds:	
First mortgage at six percent.....	\$ 750,000.
Owners' equity.....	<u>750,000.</u>
Total.....	\$1,500,000.
Income:	
Gross rentals.....	\$ 230,000.
Operating expenses.....	\$40,000.
Six percent interest.....	45,000.
Five percent amortization ...	<u>37,500.</u>
Total expenses.....	<u>122,500.</u>
Net income.....	\$ 107,500.

The effect on yield of successive reductions in gross rent is as follows:

<i>Percent Reduction</i>	0	10	40
Gross income.....	\$230,000.	\$207,000.	\$138,000.
Less expenses.....	122,500.	122,500.	122,500.
Net income.....	\$107,500.	\$ 84,500.	\$ 15,500.
Return on owners' investment	14.33%	11.27%	2.07%

PLAN NO. TWO

Sources of Funds:

First mortgage at six percent.....	\$1,000,000.
Owners' equity.....	500,000.
Total.....	\$1,500,000.

Income:

Gross rentals.....	\$ 230,000.
Operating expenses.....	\$40,000.
Six percent interest.....	60,000.
Five percent amortization....	50,000.
Total expenses.....	150,000.
Net income.....	\$ 80,000.

The effect on yield of successive reductions in gross rent is as follows:

<i>Percent Reduction</i>	0	10	40
Gross income.....	\$230,000.	\$207,000.	\$138,000.
Less expenses.....	150,000.	150,000.	150,000.
Net income.....	\$ 80,000.	\$ 57,000.	\$ 12,000. Loss
Return on owners' investment	16%	11.4%	Loss 2.4%

Comparison of the two financial plans demonstrates that the smaller equity affords opportunities of greater gains and greater losses. For, a fifty per cent reduction in gross income, ignoring any possible curtailment of expenses, will

afford a small gain where the owners contribute half the required funds, and result in a loss where the owners supply only one-third the investment.

Length of the mortgage loans.—Some mortgage loans are made for relatively short terms, such as one year to three years. At the end of that time they usually are paid off or renewed. Some mortgages are due on demand, and savings banks will allow them to run for long periods, provided the security remains unimpaired. Other loans are made for much longer periods of time, from five to ten years or more. For safety, it is often required that a long-term mortgage be *amortized*; that is, a certain percentage (from 1 to 5 per cent) is paid off each year. When a first mortgage becomes due, it is usually renewed. A renewal charge is sometimes made by banks and other lending institutions. This charge ranges from a minimum of \$10 to usually not more than one half of 1 per cent of the principal amount. Such a charge covers reinspection, reappraisal, checking of tax records, insurance, and preparation of renewal agreements. First mortgages, regardless of duration, may usually be considered in the light of permanent financing and are renewable as long as the property remains adequate security for the loan. A second mortgage, on the other hand, is temporary financing. For that reason, second mortgages provide for the paying off of the loan in installments during the life of the mortgage and are not usually renewable.

Sometime before the mortgage comes due, negotiations should be begun regarding the renewal, if such is desired, so that there will be no delay or legal action occasioned by default in payment of principal at maturity.

Steps in the obtaining of a mortgage loan.—The steps in obtaining a mortgage loan are as follows:²

1. Application for the loan.
2. Appraisal of the property.
3. Acceptance or rejection.
4. Search of title.
5. Closing of the loan.

² North, N. L., Van Buren, D., and Smith, C. E., *Real Estate Financing*, pp. 73-74.

1. *Application for the loan.*—In obtaining a mortgage loan, the borrower must make a formal application for the loan to an individual or lending institution. In this application, which may be written or oral, he states the amount of money required, the location of the property, the purpose for which the funds are to be used (*e.g.*, for erecting buildings or for installing improvements), and any matters which he considers will be of interest to the lender.

2. *Appraisal of the property.*—The lender will wish to appraise the property. If he is inexperienced in such matters, he may procure the services of an expert. Usually, if the lender is an institution, it will have in its employ those who are competent to make an appraisal of the property. Proper appraisal is so important that quite frequently the person entrusted with this function is an officer of the institution. If the appraisal is made by a third party, the lending institution may require that the prospective borrower pay the expenses.

3. *Acceptance or rejection.*—The lender will accept or reject the loan. Sometimes he may state that he is willing to loan a sum smaller than the amount desired; sometimes the entire loan will be refused. Acceptance means that the amount has been agreed upon and that the loan will be made, subject to the borrower's having good title, and so forth.

4. *Search of title.*—Once the loan has been accepted, that is, when both parties have agreed upon the amount, the borrower must show the deed and title papers. He is also required to pay the expenses of a search of title to find out whether there are any encumbrances upon or other defects in the title. The title search may be conducted by a lawyer for the benefit of the lender; some lending institutions maintain a department of their own which attends to such duties.

5. *Closing of the loan.*—If the title is found to be satisfactory and there are no liens and encumbrances which affect the desirability of the loan, or if these have been disposed of by the borrower, a day is set for the closing of the loan. A bond and mortgage similar to the one appearing in Chapter IX will be executed, and again the charge for

the drawing of the instruments is usually paid by the borrower. The money is then paid over, and the mortgage is recorded in the county recording office. The lender will ordinarily retain possession of the bond or mortgage until it is paid off.

Once a mortgage loan has been made, the borrower must realize that the lender will exercise a certain supervision over the mortgage. For instance, the lender may require the borrower to present tax receipts from time to time so as to make sure that taxes have been paid. Unpaid taxes become a prior lien. Usually, however, the lender will check the payment of taxes directly in the tax office and notify the borrower if he finds that the taxes are unpaid; he will, of course, request immediate payment. Such a check also discloses any unpaid assessments against the property. At the time a loan is made, the lender often requires that a fire insurance policy be turned over to him containing a clause that makes the policy payable to the mortgagee in event of loss. The lender will, moreover, make sure that the property is protected by new policies as the old fire insurance policies expire. Prompt payment of interest is required. Failure to keep any of the covenants in the mortgage gives the mortgagee the right to foreclose.

Leasing.—When ownership of business property is not desired, the business enterprise may acquire possession under a lease. This agreement specifies the term or duration of the lease and the rent or compensation to be paid the landlord.

The matter of leasing property may be roughly divided into two considerations: (1) the practical; (2) the legal. Mention has already been made of some of the practical problems with which the business is confronted when it decides to lease. Practical considerations largely resolve themselves into the question of what is a fair amount to pay for the use of the property. As pointed out previously, this sum is partly dependent upon expected earnings. Other practical considerations which must be raised are: the length of the term of the lease; the renewal option; the security for faithful performance; the service to be rendered by the landlord; and the expenditures, other than rent, which the lease may require the tenant to make. For example, a lease

which runs for twenty-one years may still be a good lease even though the tenant may be required to make considerable expenditures, such as erecting building and making improvements on the property, because in the twenty-one years it would be possible for the tenant to make the expenditures pay for themselves, whereas a five year lease containing the same provisions would probably be very unsatisfactory.

Oral and written leases.—Under the Statute of Frauds enacted by various states, leases running for more than one year must be in writing and subscribed by the party to be charged. Aside from this limitation which relates to the enforceability of contracts, a lease may be an oral agreement for a short term or a lengthy document containing numerous provisions and covenants. Prudence, however, dictates that every lease of whatever term be put in writing. The following subdivisions are found in all leases:

1. Date.
2. Parties.
3. Agreement to let.
4. Description of the property.
5. Term.
6. Financial statement.
7. Conditions.
8. Signatures.

There must be a definite agreement to let. The property must be adequately described. The term, the rent and the manner of payment, and the conditions must be definite. The lease must be signed by both landlord and tenant or by their agents.

Term of lease.—From the standpoint of duration, leases are classified as either short or long term. Generally speaking, there is no legal limitation on the term of a lease, which may be for one day or for 99 years.³ In New York State, however, longer term leases are customarily drawn for a period of twenty-one years with a provision for one or more renewals of similar length. This custom prevails because of

³ An exception is the provision in New York State that leases of agricultural land shall be for periods of not more than twelve years (New York State Constitution, Art. I, Sec. 13)

a law now repealed which subjected the recipient of rent on leases of twenty-one years or more to a personal property tax. Imposed along with ordinary real estate taxes, this tax was designed to discourage the tying-up of land in long leases.

Regardless of the term of the lease, the right of the tenant to use the leased property is termed a leasehold and constitutes personal property. The owner's right to receive rent and recover possession at the termination of the lease is real property. The term of the tenancy is important because of the varying legal rights involved in the various terms. Four classes of terms are recognized:

1. Monthly tenancies.
2. Tenancies at will.
3. Month-to-month tenancies.
4. Tenancies for one or more years.

Monthly tenancies.—A monthly tenancy is one with a term of one month. If at the end of a month, the tenant holds over and the landlord continues to accept rent, there is by implication a renewal for one month. This renewal may continue from month to month until terminated by either party. No notice to terminate a monthly tenancy is usually required. In New York City, however, the landlord is required by statute to give the tenant thirty days' notice of intent to terminate the lease.

Tenancy at will.—A tenancy at will is an agreement, written or oral, letting real property for a specified rental for an indefinite term. This tenancy continues at the will of either party. Thirty days' notice of intention to terminate the tenancy is usually required on the part of the tenant or landlord.

A tenancy by sufferance has also been recognized as constituting an express or implied license to use the property at the pleasure of the landlord.

Month-to-month tenancies.—Like the tenancy at will, a tenancy from month-to-month is indefinite as to term, though a specified rental is paid monthly. A statutory requirement of thirty days' notice must be given by either party to terminate the lease. It may be observed that, with respect to the landlord's rights, there is no essential difference

between month-to-month and monthly tenancies in New York City because of the statute provisions of that city relative to notice in monthly tenancies.

Tenancy for one or more years.—Tenancies for definite terms of one year or longer are more important than monthly and indefinite tenancies and, with respect to writing, must conform to the statutes of the state in which the property is located.

A tenancy for one or more years terminates without notice on the last day of the specified term of years. A tenant who continues in possession after the end of the lease is a hold-over and may be dispossessed by the landlord as such. Alternatively, the acceptance of rent from a hold-over is usually construed as a renewal by the landlord for a term of one year, irrespective of the term of years designated in the original lease. The landlord, however, may enter an agreement with the hold-over tenant that the tenancy will continue only as a month-to-month tenancy.

Payment of rent.—One of the most important phases of leasing is the manner of payment of rent. There are several methods of stipulating the manner of payment of rent, the most common of which are the following:

1. Straight rental.
2. Graduated rental.
3. Reappraisal.
4. Percentage.
5. Net rental.

The *straight rental* lease provides that the same rental shall be paid over the entire term of the lease, usually monthly in advance.

The *graduated rental* lease provides that the rent shall be in an increasing amount over the life of the lease. For example, the rent may be \$100 a month for the first year, \$200 a month for the second year, and \$300 a month for the last year of a three year lease.

The rent on a *reappraisal lease* is fixed for the first term. The annual rent on the renewal is at a fixed percentage of the value of the property at the time of the renewal.

Percentage leases provide that the annual rental shall

be a certain percentage of gross sales. The percentages given on page 391 are typical of the percentages used. The percentage leases may be with or without a guaranteed minimum rental. Suppose, for example, that a cigar store keeper agrees to pay the maximum of 12 per cent. Suppose that the annual sales are \$100,000. The rent would be \$12,000 a year, or \$1,000 a month. Such a lease may provide that the tenant shall pay a minimum rental of \$600 a month. This minimum would be paid whether the sales for any one month amounted to \$5,000 or not.

In the case of a *net rental* lease, the tenant is usually required to pay taxes, assessments, water rates, operating expenses, the cost of repairs to the building, and, in addition, a rental to the landlord, which is a net amount over and above the expenses of ownership.

General considerations affecting leases.—There are many important considerations with regard to leases which should be considered by the business man who is obtaining the use of property in this manner. One of the most important of these is the financial responsibility or standing of the landlord. If the property is mortgaged at the time the lease is entered into, a foreclosure of the mortgage, occasioned by the landlord's default, may terminate the lease. It is important for the business man to have clauses in the lease with regard to the making of improvements on the property, since, otherwise, all improvements made by the tenant become the property of the landlord. If the business man is at all in doubt as to the safeguarding of his interest in a lease, he should obtain competent legal advice in the matter.

Title insurance and examination of landlord's title.—Reference will be made to *title insurance* in the next chapter on "Insuring Against Business Risks." No business enterprise should acquire the ownership of real estate or become the tenant under a lease for any considerable period of time without being certain that the ownership, or *title* as it is technically called, is clear. This point is well understood by most business men with reference to the purchase of real estate. They would not think of buying property without having its title examined, and, if possible, insured,

in order to make certain that the ownership is free from encumbrances other than those agreed upon. It is not so well realized, however, that the same careful examination should be made when a business becomes a tenant under a fairly long term lease. It is important in such a case to ascertain that the landlord owns the property and that his ownership is not subject to conditions which might abrogate the lease or prevent the property from being used for the purpose which the business has in mind. Private or zoning restrictions, for example, might exist of a character which would prevent the carrying on of a certain type of business. Similarly, should the landlord's ownership be subject to a large mortgage, the danger of foreclosure may exist.

General legal nature of real estate problems.—The preparation of instruments of title, liens, and leases is best entrusted to an attorney. Custom, court decisions, and statutory requirements have resulted in the building up of many forms and precedents which must be followed if the correct legal significance is to be given to the documents. The business man wishes to obtain the use of business property without interference or chance of eviction. He should have competent legal advice as to his rights and obligations in any real estate transactions which he may undertake. Since the average concern has but few of these transactions in comparison with the rest of its business, the business man cannot hope without considerable study to deal as expertly in such matters as an attorney who is trained for such work. The chance of loss is so great that the expenditure for legal advice is more than justified thereby.

Government in real estate financing.—The depression of the early thirties forced the government to take steps to prevent foreclosures, liquefy mortgages, help home owners and farmers, and in short to prevent the threatened collapse of the entire mortgage lending structure. Many state legislatures declared a moratorium on foreclosures for non-payment of principal. Bankruptcy laws were amended to permit the reorganization of real estate mortgage bond issues. Government agencies were also set-up financially to assist banks, insurance companies, building and loan associations and other mortgage-lending institutions.

The Reconstruction Finance Corporation represented the first step taken by the Federal Government to meet mortgage problems arising from the depression. The R. F. C. loaned money to financial institutions and other corporations on acceptable collateral, some of which were bonds and mortgages. To aid those engaged in the business of farming, the farm loan functions of the various agricultural agencies were then expanded and the Federal Land Bank System entirely overhauled.⁴

The next steps were the formation of the Federal Home Loan Bank System and the Home Owners Loan Corporation. Under the Federal Home Loan Bank Act a federal reserve system was set-up for home mortgage lending institutions. The H. O. L. C. in turn was formed to protect home owners against loss of their homes through foreclosure. It was also designed to place home mortgage lenders in a more liquid condition by setting-up facilities for exchange of their troublesome mortgages for marketable, government-guaranteed H. O. L. C. bonds.

Congress then enacted the National Housing Act, which was designed to set-up a sounder system of home construction and home financing under the supervision of the Federal Housing Administration. Enacted as an emergency law in June, 1934, the Federal Housing Act was designed to encourage construction and alteration of homes and thereby to reduce unemployment among those normally earning a livelihood from industries connected with the building business. Under this act, qualified mortgage lenders may procure from the Federal Government a guarantee of the payment of a first mortgage on a dwelling housing four families or less. The borrower must offer satisfactory proof that he is financially able to meet the loan provisions.⁵ If the mortgagor defaults, the qualified mortgage lender as mortgagee, may acquire title by foreclosure or otherwise. This he conveys to the Federal Housing Administrator in exchange for three per

⁴For a summary of the provisions of the Federal Farm Loan Act, refer to Benson and North, *Real Estate Principles and Practices*, pp. 313-316.

⁵For a summary of requirements that must be met by borrower and qualified mortgage lenders, refer to Benson and North, *Real Estate Principles and Practices*, pp. 311-313.

cent debenture bonds of the Mutual Insurance Fund established by the act. These debenture bonds run for three years after maturity of the foreclosed mortgage and are guaranteed by the Federal Government for an amount equal to the unpaid balance of the mortgage, plus interest, taxes and insurance premiums, if any, paid by the mortgagee.

By means of the government guarantee of loans within specified limits and for designated purposes, the Act serves not only to encourage real estate financing but also to eliminate exorbitant financing costs and those malpractices largely responsible for losses in this field. Among the features of the new home mortgage financing plan which will afford these benefits may be mentioned the following:

1. Standards prescribed for home construction and neighborhoods.
2. Provision for more careful inspection and appraisal of homes for mortgage lending purposes.
3. Limits set on loan values and maturity dates.
4. Standardization of fees and elimination of second mortgages and recurring renewal fees.
5. Lower interest rates.
6. Reduction of loans through amortization.
7. Protection of mortgage lenders through mutual mortgage insurance.

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Questions for Study and Review

1. Discuss the two primary problems of the business man in connection with real estate.
2. What is meant by *pedestrian traffic analysis*, and what is its relation to the problem of calculating the possible rental?
3. Discuss four factors involved in choice of a factory site.
4. What average percentage of sales has been set as the maximum rent percentage for retail stores?
5. What factors determine the amount of real estate which a business should purchase?
6. List nine types of loans for financing real estate and explain the suitability of each.
7. Name five sources of mortgage loans.

8. Demonstrate the relationship between the proportionate equity in real estate and vulnerability to vacancy losses.
9. Discuss five steps in the obtaining of a mortgage loan.
10. Must leases be in writing?
11. State the main subdivisions of a lease.
12. Distinguish between monthly tenancies and month-to-month tenancies.
13. What is the nature of a tenancy at will?
14. What rights are recognized under tenancies for a fixed number of years?
15. What is a hold-over tenant?
16. Explain five methods stipulated for the payment of rents.
17. Should a lessee investigate the landlord's title to the property and his financial standing? Explain.

Problems

1. You have been employed by a New York City chain cigar store to act as their locations man. What policies would you adopt with respect to the choice of locations? How would you go about the job of choosing suitable locations?

2. The XYZ Shoe Company, manufacturers and retailers of men's, women's, and children's shoes, has been offered five sites for new stores. They expect to locate at least two this year. Which of the following should they choose?

	<i>Estimated Sales</i>	<i>Rental Asked</i>
(1)	\$200,000	\$12,000
(2)	125,000	10,000
(3)	350,000	50,000
(4)	75,000	8,000
(5)	60,000	9,000

3. Your firm, which is in the restaurant business, is about to enter into a lease of 5,000 square feet of ground floor space on Fifth Avenue in New York City. Discuss some of the things which should be considered before entering into this lease.

4. The OK Department Store is considering buying a new site in the center of a fast growing retail shopping district. The desired plot is 200 and 400 feet. The price asked is \$50 per

square foot. There is an old building on the plot on which exists a 10 year first mortgage of \$175,000. The new building is to cost approximately \$6,000,000. Suggest various means of financing the property.

5. Your firm, a company in the retail candy business, is about to enter into a lease for space. You are called in to advise the president regarding the best kind of lease to sign. What factors should you stress in discussing the problem with him?

6. The tax rate in city *A* is \$3.50 for \$100 of assessed value. The assessment rate is 60%. The tax rate in city *B* is \$2.70 per \$100 of assessed value, and the assessment rate is 100%. From the standpoint of tax burden, in which city should a manufacturer prefer to locate?

CHAPTER XXII

Insuring Against Business Risks

Business risks.—Every venture in life is attended with risk. Every human activity faces the danger of becoming a failure as the result of unfulfilled promises or as the result of catastrophies such as fires, cyclones, floods, etc. For practically every type of business risk, however, there is some form of insurance which furnishes partial, if not complete, protection against loss.

The difficult problem for the business man is to determine exactly what the outstanding risks of his business are. The solution to it is, then, at as low a cost as possible, to protect himself against those catastrophies which may unexpectedly occur. The determination of the outstanding risks of a business is a matter of careful analysis. For example, authorities claim that no part of this world is immune from earthquakes. For instance, London experienced in 1931 for the first time in a thousand years an earthquake of noticeable severity. But if earthquakes come only once in a thousand years, it is hardly advisable for a London business man to carry earthquake insurance. In other parts of the world where earthquakes are a very common event, it is advisable to carry such insurance. The following list includes common risks of loss against which insurance may be taken:

1. Loss due to death of an invaluable employee or partner.
2. Fire loss.
3. Loss of income from rents due to fire.
4. Loss of profits due to fire.
5. Water damage from sprinkler leakage.
6. Water damage.

7. Damage or loss of goods in transit.
8. Riots, civil commotions and malicious mischief.
9. Explosion damage.
10. Earthquake damage.
11. Windstorm damage.
12. Hailstorm damage.
13. Flood damage.
14. Loss due to rain.
15. Automobile collision, fire and theft, automobile accidents.
16. Aviation accidents.
17. Building accidents.
18. Elevator accidents.
19. Loss of wages due to injury to employees.
20. Boiler explosions.
21. Flywheel breakage.
22. Engine breakdown.
23. Plate glass breakage.
24. Mysterious disappearance of property.
25. Defects in land titles.
26. Forgery losses.
27. Infidelity of employees.
28. Unfulfilled contracts.
29. Credit losses.

Although the above do not include all of the risks to which a business is subject, the list presents the main causes of loss.

Risk-bearing plans.—There are two ways by which risks can be offset and the business protected against the danger of losses. The first is to transfer the risk to an insurance company, and the second is to carry self-insurance.

Before the significance of the risk-bearing plans can be thoroughly grasped, it is necessary for the reader to understand the theory of insurance. Professor Ackerman, in his work on *Insurance*,¹ describes the theory of insurance as follows:

“Insurance distributes the cost of the risk over a large group of individuals subject to the same risk, in order to reimburse the few who

¹ Ackerman, Saul B., *Insurance*, p. 7.

actually suffer from the risk. For example, a study of past statistics in a city of 2,000 houses, each valued at \$10,000, may indicate that each year there are losses by fire amounting to \$10,000. Every owner, therefore, knows that some of the houses will be damaged by fire and it is possible that his house may be one of those which will be burnt. Theoretically, if the owners annually contributed to a common fund \$5 for each owner, the risk would be covered, and each owner would be freed from the fear of financial loss through fire. This principle of distributing risk is the basis of all insurance.

"Insurance is a social device whereby one party, the *insurer* or insurance company, agrees to meet certain stated risks in return for a money consideration paid by a number of other parties, the *insured*. The money consideration is called the *premium*. A fire insurance company, for example, will, in consideration of the payment of a premium, issue a contract called a *policy*, in which the insurance company agrees to reimburse the insured for a fire loss but not in excess of the amount stated in the policy and with the provision that the loss must occur during the period through which the policy runs."

Self-insurance operates through the setting aside of funds over a period of time; the amount of these funds should be sufficient to cover the various losses. If losses occur before adequate funds have been built up to cover the losses, the plan obviously does not give the desired protection. On the other hand, if losses never occur or if the losses are negligible, then the funds may ultimately be released for other business purposes.

Loss prevention should be an important part of any risk-bearing plan, because it enables insurance companies to charge lower premium rates and to diminish the cost if insurance is carried. "Safety first" is one of the best types of insurance. Risks can be reduced to a minimum by installing loss prevention equipment, by avoiding risks, and by educating those concerned to guard against all possible loss.

Contingency reserves or a large surplus account may be used for protection against possible losses, but this is actually *non-insurance*. If this plan is followed, the reserves and the surplus must be in liquid form in order that, when the contingency arises, the money will be available to cover the loss. Mr. O. V. Rodriques, in the *Financial Handbook*,² has made a very fine distinction between non-insurance and

² Montgomery, R. H., *Financial Handbook*, 1927, Section 5, p. 657.

self-insurance in connection with the fire hazard; his explanation reads as follows:

"Self-insurance.—Self-insurance is the assumption of the risk by the owner of property, who lays aside periodically sums estimated as adequate to provide in time a fund sufficient to reimburse him for any losses which may occur. Where plants are scattered over the country, isolated in most cases, and the class of business, together with the construction of the property, is such that fire hazards are greatly minimized, such insurance may be successfully undertaken by the owner. The chances for the success of a self-insurance plan would be greatly enhanced if, during the period of accumulation of the fund, insurance in other organizations were used to supplement the plan, this supplemental insurance being gradually reduced as the fund is increased.

"Non-insurance is not self-insurance.—Self-insurance should not be confused with the assumption of risks without any provision for losses when they do occur. Every man who does not insure his property carries this latter so-called self-insurance, but if he is in business, the interest of his bankers, creditors, customers, and employees must be considered. The essence of insurance is the provision for prompt indemnification of losses; and where this principle is not observed, insurance cannot be said to exist. Even where reserves are set aside but no actual segregation of promptly convertible assets is made, the principle of insurance is not properly observed. A sound business would require, not merely a bookkeeping entry, but also the accumulation of a fund invested in quickly convertible securities, kept virtually in trust."

Insurable interest.—There are several important principles of insurance. One of these refers to *insurable interest*. If a person insures a building that he does not own, he will not be able to collect on his policy in case a loss occurs. The reason for this is that the principle of insurable interest requires that, *in order for the insured to be able to recover in case of loss, he must be able to show that he suffered a monetary loss when the property was damaged*. If the insured did not own the property, he would be unable to show such a monetary loss. Important examples of insurable interest are:

1. The interest of an actual owner.
2. The interest of a lessee.
3. The interest of a mortgagee.

The *insurance contract* or *policy* is a contract between the company or insurer and the insured. In order to enable

the reader to understand the characteristics of a policy, reference will be made to the fire contract which is known generally as the standard fire insurance policy. The latter contains the following main provisions:

1. The parties.
2. A description of the property.
3. The amount of insurance.
4. The rate.
5. The total charge or premium.
6. The protection given.
7. The provisions affecting the commencement and the termination of the insurance contract.
8. The provisions which void the contract.
9. The procedure in settling for a loss.

It is important that the insured know when the contract is legally in force. *The risk must have been accepted by the insurance company.* The delivery of the policy is not essential to make the insurer liable. Frequently, a *binder* is used in insurance covering property to indicate an acceptance of the risk by the insurance company. This is a temporary agreement which binds the company prior to the issuance of the policy.

Insurance contracts are usually terminated by the expiration of the term for which the policy was issued, cancellation by the insured, cancellation by the insurer, or by the occurrence of an event stipulated in the policy. In most instances, the insurance contract may be voided if the insured commits a fraudulent act. The loss in many policies is payable within 60 days after a proof of loss has been received by the company.

Because of certain legislative requirements, in many states an insurance company cannot issue a policy unless the provisions have been approved in advance by the State Insurance Department. In addition, insurance rates, duties and obligations of representatives of insurance companies, investments, and treatment of policyholders are very closely supervised by the state. Generally, the law requires that insurance companies file financial statements annually, and these statements are open for inspection by the public.

The various forms of insurance that can be obtained are divided into six groups:

- I. Life insurance.
- II. Fire insurance.
- III. Casualty insurance.
- IV. Marine insurance.
- V. Fidelity and surety.

I. Life insurance.—This is the most important branch of insurance. Its primary purpose is to protect dependents. There are four important life insurance policy contracts. These are (1) *term insurance*, (2) *whole life insurance*, (3) *limited payment life insurance*, and (4) *endowment insurance*. A term insurance policy provides protection for a definite number of years, and the policy becomes a claim provided the insured dies within the period stated in the policy. The annual cost of a term policy is lower than that of a whole life policy. The whole life insurance policy provides protection for the insured's dependents during the life of the insured: the policy matures at the time that the insured dies. A limited payment life insurance policy requires the insured to pay premiums for a definite number of years, for example, 20 years: after the twentieth year, the insured pays no more premiums; however, whenever the insured dies, the claim matures. An endowment policy requires payment of premiums for a definite number of years, for example, 20 years: if the insured dies before the twentieth year, his dependents will receive the face value of the policy; if he survives the twentieth year, he will receive the face value of the policy.

The insurance law regulates the provisions which must be inserted in every policy contract issued by a life insurance company. The important clauses of a life insurance policy are those relating to:

1. *Grace period*, requiring that the insured be permitted to pay his premium with 30 or 31 days after the premium is due without lapsing the policy.

2. *Incontestability*, providing that, after a certain period of time that varies from 1 to 2 years, the policy is incon-

testable by the insurance company except for the non-payment of premium or the misstatement of age (if there has been a misstatement of age, the amount payable will be modified according to the insured's age).

3. The *beneficiary*, providing that the policy shall be payable to the person named in the policy by the insured. There are two forms of beneficiaries: *revocable* and *irrevocable*. If the beneficiary is revocable, the insured can substitute the name of a new beneficiary at all times. If the beneficiary is irrevocable, the insured gives up his right to substitute a new beneficiary during the beneficiary's life without the consent of the irrevocable beneficiary.

4. *Non-forfeiture values*, that is, cash surrender value, extended insurance, and paid-up insurance. Premiums paid under certain policy forms, such as whole life, limited payment life, or endowment, are used partly to pay current claims and expenses and partly to create a reserve to help meet future claims. By statute, the purchasers of these policy forms are entitled to a share in the reserve, which share is designated as the cash surrender value available to the policyholder after he has paid a definite number of premiums. The cash surrender value at the end of each year must be printed in the policy. If the insured desires, he can surrender his policy and receive his share in the reserve. If he accepts this amount, he thereby surrenders all his rights under this policy. However, he has the privilege of borrowing the cash surrender value from the insurance company and paying interest on this amount: in the meantime, the policy remains in force for the face amount of the policy reduced by the amount of money that has been borrowed by the assured.

5. *Extended insurance option*.—If the assured does not desire to continue his policy and does not demand the cash surrender value, he has two options. He may ask the company to grant extended insurance for the face amount of the policy for a specific number of years, which is stated in the policy, or he may request a paid-up insurance option.

6. *Paid-up insurance option*.—If he desires, the assured may use his cash surrender value to purchase paid-up insurance for an amount smaller than the face value of the policy.

Business life insurance.—An important use of life insurance is to protect business against the loss of an invaluable employee or partner, or a stockholder, in a corporation which has a very limited number of stockholders. This is called *business life insurance*. Business experience tends to show that man power, executive ability, leadership, vision, and personality in members of an organization are qualities that can be built and developed but not bought over the counter. Many successful concerns have found themselves seriously handicapped by the loss of one or more of their best employees, partners, or executives. Many a partnership has found it very difficult, on the death of one of the partners, to raise enough money to settle with the heirs of the deceased. The advantages of carrying business life insurance were very well stated by the late John Wanamaker, who said, "Twenty years ago I had a capital of about a half million dollars. I then realized that a business man with a half million dollars of capital and one million and one half of insurance on his life would have better credit in his business than one with a half million capital and no insurance—and so I took the insurance. I now find that, by trading on the credit it created, I have made more profit than I would have made if the money which went into insurance had gone directly into my business."

Business insurance may be purchased especially to accomplish one definite end, but generally it will accomplish at least one of the following:

1. Furnish funds to replace an invaluable employee or partner who has been lost by death.
2. Supply the money needed to retire the interest of a deceased partner or stockholder.
3. Provide an emergency reserve, since money can be borrowed on the policy.
4. Stabilize and strengthen credit.
5. Retire individuals at old age.
6. Retire business obligations.

Life insurance trusts.—A life insurance trust is a trust established by the insured to place the proceeds of life insurance policies in the hands of a trustee, to be distributed

according to definite terms established in the trust agreement. This procedure may also be used in business. If life insurance is purchased to retire a partner's or a stockholder's interest, care should be taken in the naming of the beneficiary. If *A* and *B* are partners, it is inadvisable to make *B* the beneficiary of *A*'s policy and *A* the beneficiary of *B*'s policy. If *A* should predecease *B*, *B* would be entitled to the money under the life insurance policy in which he was named beneficiary. However, there is no guarantee that he would use this money to purchase from the estate of *A* the interest of *A* in the partnership of *A* and *B*. In fact, if he were in a poor financial condition, creditors might levy on the money which he had collected from the life insurance company. In order to avoid this contingency, it is advisable to prepare a special agreement called the *life insurance trust*. Under this agreement, which is signed by the partners, a third party is named the beneficiary; for example, *C* is made the beneficiary of *A*'s policy and *B*'s policy. The beneficiary under the terms of the agreement is usually required to collect the money from the life insurance company and to pay the money to the estate of the deceased partner, in consideration of which the estate of the deceased partner assigns its interest in *A*'s and *B*'s partnership to the survivor. Similar practice should be followed in connection with the life insurance policy purchased to buy the interest of deceased stockholders.

Group insurance.—To develop loyalty among employees, business men have purchased group insurance to protect the dependents of the employees who die while on the payroll of the employer. The premium may be paid by the employer, or the employee may contribute with the employer. The policy is issued to the employer and each employee receives a certificate stating the amount of insurance protection to which his beneficiary is entitled. All rights under the certificate terminate as soon as the employee ceases to work for his employer. However, the former employee is entitled to a policy in his own name provided he pays the rates charged by the insurance company at the age of the employee when the employment was terminated.

Industrial pensions.—Some firms have introduced industrial pensions. These pensions provide protection for employees when they reach a certain specified age. Some of the factors upon which the payment of pensions depends are: (1) the length of service of the employee before retirement; (2) the amount of the annual wages of the employee. Funds to pay the pension may be accumulated by the employer and set up as a reserve. Of course, there is the danger that the reserve may be inadequate to meet all pension payments. In addition, all interest that the employee may have in the pension fund ceases as soon as the employee leaves his employer. There has been a tendency in some cases to purchase a contract with a life insurance company whereby the employee obtains the right to a certain amount of the deferred pension for each year that he works, payment by the life insurance company to commence at the retirement age. Under this arrangement, the right of the employee to the pension from the life insurance company continues whether or not he remains in the same employment.

II. Fire insurance.—The most important policy in this group is the standard fire insurance policy, from which coverage the group takes its name. In this group are included policies which cover damage to property owned by the insured, such as losses due to sprinkler leakage, water damage, windstorm, tornado, earthquake, explosion, riot, civil commotion, hail and rain.

It is hardly necessary to say much concerning the fire risk. The continual clang of fire bells and the shrill call of the siren constantly remind everyone that fire losses are occurring every day. The annual fire loss is estimated to be in excess of a half billion dollars. Fire prevention authorities believe that the financial loss could be reduced if proper care were exercised in enacting adequate building laws that required the elimination of fire hazards, and in the maintenance of an efficient fire department.

Fire policy provisions.—The standard fire policy embodies the following:

1. A description of the property.
2. The risk which the company assumes.

3. The duties to be performed by the insured in the event of loss.
4. The contribution to be made by each company if several companies have insured the same property.
5. The method of determining the amount of the loss.

Risk which company assumes.—Perhaps the most important provision as far as the insured is concerned is the risk assumed by the company. The company has to pay for any fire loss unless the hazard has been increased after the policy becomes effective. The insurance company does not agree to pay for losses due to all contingencies. The policy provides that losses due to certain circumstances are not covered, including: (1) losses occurring as a result of war, riot, civil commotion; (2) losses incurred by act of civil authority; and (3) losses caused by theft. Losses due to explosion or lightning are not covered unless fire ensues, and then the policy covers for the loss due to fire. It is customary, however, for the insurance company to assume by *endorsement* loss due to lightning. (An endorsement is an added clause affixed to the original policy.)

Duties to be performed by the insured in the event of loss.—After a loss has occurred, the insured must notify the company immediately. He must separate the damaged goods from the undamaged goods, and then prepare a statement of loss, which he must file with the insurance company.

Contribution.—Frequently an insured obtains several policies from various companies, as one company may not be willing to insure his property for the amount that the insured desires. For example, suppose the cash value of his property were \$160,000. The insured might obtain policies from four different companies: from Company A, for \$50,000; Company B, for \$40,000; Company C, for \$10,000; and Company D, for \$60,000. Now, assume that the property is damaged by fire to the extent of \$20,000. In accordance with the terms of the policy, each of the companies must pay the owner in proportion to the amount of insurance that each company carries. The amount of insurance will be determined as follows:

$$\text{Company A } \frac{\$50,000}{\$160,000} \times \$20,000 = \$6,250.$$

$$\text{Company B } \frac{\$40,000}{\$160,000} \times \$20,000 = \$5,000.$$

$$\text{Company C } \frac{\$10,000}{\$160,000} \times \$20,000 = \$1,250.$$

$$\text{Company D } \frac{\$60,000}{\$160,000} \times \$20,000 = \$7,500.$$

Method of determining amount of loss.—The insurance company may send a representative to determine the amount of the loss. If the insurance company cannot agree with the insured as to the amount of loss, the insured cannot commence a suit to recover the amount which he claims. However, the policy provides that the insured must appoint an appraiser and the company must appoint an appraiser. After these appraisers are appointed, they must meet and appoint an umpire. The two appraisers must then determine the amount of the loss. If they agree on an amount, the insurance company is required to pay the amount so determined. If the appraisers are unable to agree, it is the duty of the umpire to ascertain the amount of the loss; this amount must then be paid to the insured.

Coinsurance clause.—An endorsement that is frequently attached to the fire insurance policy is known as the *coinsurance clause*. This clause requires the insured to carry a certain amount of insurance, which is measured by a percentage of the cash value of the property. A common percentage is 80 per cent. The reason for the insertion of this clause is that rates quoted by insurance companies covering the fire risk vary because they are based upon the certain percentage of his property on which the insured is required to carry insurance. The higher the percentage required by the insurance company, the lower will be the rate. In other words, if 100 per cent insurance is required, the rate will be lower than if 80 per cent insurance is required. Obviously, the rate will be lower if 80 per cent of insurance is required than if, for example, only 20 per cent of insurance were required to be carried. The effect of the operation of this clause may be

seen from the following illustration. Assume that the cash value of the property is \$175,000 and the rate paid by the insured is based upon the assumption that he will carry insurance up to 80 per cent of the valuation of his property. The insured has a policy for \$120,000. A fire occurred, and the damage amounted to \$35,000. In view of the fact that the amount of insurance required was \$140,000, that is, $.80 \times \$175,000$, and only \$120,000 was carried, the insurance company will pay the loss determined from the following arithmetical computation:

$$\frac{\$120,000}{\$140,000} \times \$35,000 = \$30,000.$$

Modern business has seen the rise of many industrial organizations which have factories and warehouses in various parts of the United States. The standard fire insurance policy does not meet the need of these organizations, since the standard fire insurance policy covers goods at a specific location. If a firm has 60 branches, it would be expected to require 60 policies. Furthermore, it would be necessary to take great care in order to be certain that the policyholder was fully protected for the stock which might be in any branch at any one time. For example, stock might be received in a branch although the central organization might not have the notice of the receipt of additional stock. In the meantime a fire might occur with loss to the policyholder on account of insufficient insurance. To meet the need of these organizations, fire insurance companies issue a special policy form, which, subject to limitation, will protect the assured, since the premium is determined by a report from the insured at the end of each month for the various locations where the insured has property.

The fire insurance policy is generally a contract of indemnification. If the insured is manufacturing an article for which the total cost is \$10 and the selling price \$11, the manufacturer is entitled under the policy to \$10 for loss by fire. No consideration is given to the fact that the article was manufactured under contract for sale at \$11 or could have

been sold at \$11. However, the insurance company will issue a policy agreeing to pay the loss of profit for goods ready for sale but destroyed by fire.

In addition to the loss of profit on goods manufactured, the manufacturer may suffer additional loss, since his plant cannot operate until it has been repaired and he has again obtained materials in order to start manufacturing operations. The loss resulting from inability to operate may be far greater than the loss to the articles damaged by fire. Although the fire has occurred and the assured has been reimbursed for the articles damaged, there are certain expenses which continue after the fire even though the plant cannot operate. Some of these are interest payments on bonded indebtedness, taxes on real estate, salaries to employees under contract, and payments on advertising contracts. In addition, there may be a loss on profits not earned owing to inability to manufacture. To cover such losses, the fire insurance companies issue a *use and occupancy* policy, which will indemnify the assured for loss of fixed charges and profits which could not be earned during the period after the fire and before operations could again be commenced.

Sprinkler leakage and water damage insurance.—In order that the fire hazard and also the fire insurance premium may be reduced, automatic sprinkler systems have been installed in many establishments. These systems have water pressure outlets located throughout the buildings. Their outlets or taps open automatically when the temperature reaches a danger point. Sometimes they open accidentally. Protection against damage from this cause can be obtained through *sprinkler leakage insurance*.

Water damage insurance protects property owners against loss due to damage to property resulting from the use of water in buildings. This policy excludes damages caused by automatic sprinkler systems. The most common hazards are damage done by:

1. Bursting water pipes, due to defective plumbing.
2. Leaking system pipes.
3. Overflowing tubs and basins.

4. The collapse of supply tanks.
5. Rain water damage from defective roofs, spouts, open windows, or skylights.
6. Frozen pipes.

Hail insurance is written primarily for the farmer. It protects against damage done to crops by hail. Most policies provide that the insurance ceases when the crop has been harvested. Liability usually accrues to the company when the damage exceeds an agreed percentage of the total insurance carried.

Rain and hail insurance.—*Rain insurance* is not primarily for protection against the damage actually done by rain water; rather, it aims to protect business men and promoters against financial loss on account of rain. Types of business which need protection against the losses that rain may cause are:

1. Baseball games.
2. Football games.
3. Prize fights.
4. Auction sales.
5. Races.
6. Carnivals.
7. Fairs.
8. Rodeos.

Windstorm, tornado, and earthquake insurance.—*Windstorm and tornado insurance* protects the insured against loss directly due to windstorms, cyclones, and tornadoes. In some sections of our country this is a very important form of insurance, since hardly a season passes without some damage from these causes. The policies usually exclude losses due to blizzards, snowstorms, fire, explosions, lightning, cloudbursts, tidal waves, or high water. Fire insurance should also be carried under such circumstances, because very often fire completes the damage started by a windstorm or a cyclone.

Earthquake insurance policies, like most insurance policies, protect against any loss which is the direct result of one or more causes. In this case, it is an earthquake or volcanic

eruption. The exclusions are almost identical with those included in the windstorm and tornado policies. It is advisable, again, to properly supplement an earthquake policy with a fire clause.

Riot, civil commotion and explosion policies.—These policies cover destruction of property as a result of riot, strikes, insurrection, civil commotion and explosions.

III. Casualty insurance.—Insurance companies that write this branch of business confine themselves mainly to the following kinds of insurance:

1. Automobile insurance.
2. Workmen's compensation insurance.
3. Burglary, larceny, and theft insurance.
4. Miscellaneous public liability insurance.

Automobile insurance.—The principal hazards due to the operation of an automobile are injuries to the public and damage to their property. In order to protect himself, the owner of an automobile should purchase an automobile bodily injury policy and an automobile property damage policy. The *automobile bodily injury policy* protects the insured against financial loss on account of the liability of the automobile owner to others for bodily injuries accidentally sustained, including death resulting from the accident injury.

In addition to agreeing to pay for any financial loss sustained by the owner of the automobile, the insurance company will defend any action against the insured, investigate and settle claims, and pay first-aid expenses without regard to the ultimate liability of the insured. Usually one clause of the policy provides that the insurance company is responsible for injuries caused by anybody who is driving the automobile with the permission of the owner.

The standard limit for which the policy is written is \$5,000 for injury to one person in one accident. If two or more persons are injured in one accident, the standard limit is \$10,000, nevertheless subject to the limit of \$5,000 for each person injured in the accident. Upon payment of an additional premium, the limits can be increased.

The insurance company is not responsible if the accident was caused while the automobile (1) was used in connection

with any prearranged race or speed contest; (2) was operated by any person under the age limit fixed by law or, in any event, under fourteen years of age; or (3) was used for any purpose other than that mentioned in the policy.

Automobile property damage insurance protects the insured against loss on account of his legal liability for damage done to the property of others. In addition to indemnifying for damage to the property of others, the policy also covers liability for the loss of the use of the property of others due to the accident.

It is the practice of insurance companies to write automobile property damage insurance in the same policy with the automobile bodily injury insurance. The standard limit for which the automobile property damage coverage is \$5,000 for any one accident. Upon payment of an additional premium, higher limits can be obtained. In connection with the two coverages previously described, the owner of an automobile sometimes purchases *automobile collision insurance*. This form of insurance indemnifies the owner of the automobile on account of damage done to his own car as a result of collision, including upset. The insurance company will repair the car or pay the cost of the damages.

Frequently, collision coverage is issued with a *deductible clause*; for example, the \$50 deductible clause. In the event that an insured who has purchased collision coverage suffers damages to his car to the extent of \$175 as a result of collision, the insurance company will pay \$125; that is, \$175 less \$50.

Workmen's compensation insurance.—This form of insurance protects an employer for injuries to his employees arising from, and in the course of, his employment. The insurance company agrees to pay any award which may be made against the employer under the Compensation Law. (Most states have a compensation law.) By virtue of this law, which disregards the question of negligence of the employee, employees are awarded payments for injuries caused during their employment.

Since the introduction of workmen's compensation insurance provides protection to injured workers during the course of their employment, many have felt that various other haz-

ards which employees must meet should be eliminated by financial contribution from the employer. Some of these hazards are (1) unemployment, (2) sickness, and (3) old age. In most instances it will be impossible for the individual employer to provide adequate protection against these hazards, and he will therefore be required to participate in a pool formed by various employers.

Burglary, larceny, and theft insurance.—Because of the frequency with which thefts occur, insurance companies have developed policies which protects against such contingency. Two forms of this insurance are used extensively by business men:

1. Mercantile open stock burglary policy.
2. Robber policy.

The *mercantile open stock burglary policy* protects the business man against burglary when his place of business is closed. In order to be able to recover for any loss, the insured must show that entry was made by the burglars with actual force and violence and that they left visible marks on the premises at the place of entry as a result of the use of tools, explosives, electricity, or chemicals.

Robbery insurance, as distinguished from *burglary insurance*, protects the insured during the regular course of business. There are three different forms of robbery policies:

1. Messenger robbery policy.
2. Paymaster robbery policy.
3. Office or store robbery policy.

The *messenger robbery policy* insures against loss due to robbery from the person in charge of the property while he is outside of the premises of the insured.

The *paymaster robbery policy* insures against loss due to robbery of the paymaster outside or inside the premises of the insured.

The *office or store robbery policy* insures against loss from a custodian while on duty within the premises.

Miscellaneous public liability insurance.—As a result of the operation of any business or any undertaking, the owner or his employees may cause injuries to others for which the

owner may be held responsible. For example, a piece of iron may fall from a building during the course of its erection and injure a passer-by. The contractor would be held responsible if it could be shown that the accident was due to negligence on his part. Protection against this hazard can be obtained by the purchase of *public liability insurance*. Some of the common forms of public liability insurance are:

1. Manufacturers' and contractors' public liability insurance.
2. Owners', landlords', and tenants' public liability insurance.
3. Elevator public liability insurance.

IV. Marine insurance.—This form of insurance, which is similar to fire insurance, protects owners of cargoes against loss while the property is being transported on boats. The *marine insurance policy* offers coverage against numerous hazards instead of a single hazard, as is the case in fire insurance. It is not merely confined to protection against loss on account of fire but may be said to be an all-risk policy, covering the assured against practically all important hazards which may cause a loss. Marine policies are also issued to cover the loss of the hull, as well as the loss of freight charges.

Many insured have objected strenuously to the fact that they have to purchase many policies in order to cover the various risks from which they might suffer losses. This is especially true where goods are transported to various parts of the country. To meet this objection, many insurance companies issue policy contracts known as *inland marine policies*. An important inland marine policy form is the *transportation policy*. This policy is in many respects very similar to the marine insurance policy. While marine insurance essentially provides protection on the high seas, the transportation policy provides protection for goods in transit by rail, express, airship, and coastwise steamers.

V. Fidelity and surety.—Every business man who engages an employee to handle funds or goods is confronted with the possibility that such an employee may steal the funds or the goods. Frequently, an employer has found after many years of employment of a trusted employee that

the latter has violated his trust. An employer can obtain a fidelity bond which protects him against loss due to defalcation by his employees. The essential purpose of a fidelity bond is to guarantee the honesty of the one who is bonded. If an employer desires, he can have a separate bond covering each of his employees. On the other hand, he can obtain one bond covering all employees, which is known as a *schedule bond*, listing all employees in a schedule attached to the bond. In addition to guaranteeing the honesty of individuals, fidelity and surety companies undertake to guarantee the performance of contracts. For example, a city may desire to construct a building. The lowest bidder may be awarded the contract. However, before the contract is issued, the municipality generally demands that the contractor must agree to finish the building for his bid. In order to guarantee to the city that he will complete the work, the contractor can obtain a surety bond called a completion bond.

The purpose of a surety bond is to guarantee performance of an act.

Social Security Legislation.—The Federal Government passed the Social Security Act in 1935. The purposes of the act are to provide for unemployment benefits, old age pensions, and other social aids.

The Act provides for a Federal contributory pension plan. Employers are taxed on their payrolls and employees a like percentage on their wages up to a specified amount, beginning with one percent annually on January 1, 1937 and graduated to reach three percent for each group in twelve years thereafter. The tax is subject to wages up to \$3000 annually. Monthly benefits will be paid to workers who reach the age of 65 on or after January 1, 1942 provided he has earned not less than \$2000 since January 1, 1937. If the worker reaches the age of 65 prior to January 1, 1942 or if he reaches the age of 65 after January 1, 1942 and has not earned \$2000 since December 31, 1936 he will receive a lump sum benefit depending on the amount contributed by the employer and the worker.

The Act also provides for unemployment benefits, the employer, only, paying a tax, which began with one per cent on

payrolls on January 1, 1936 and reached a maximum of three percent on and after January 1, 1938. Unemployment benefits depend upon the individual states setting up plans acceptable to the Federal Government for the administration of such benefits. Once the plan of the individual State is approved by the Federal Government, the State becomes entitled to receive Federal contributions from the Social Securities Funds under the terms of the Act.

The agent and the broker.—Insurance is frequently purchased through an agent or a broker. There is a legal distinction between an agent and a broker. An agent is appointed by a specific insurance company to represent the company. When the insured places an order for a policy with him, he collects the premium and receives the commission from the insurance company as a reimbursement for his efforts. Legally, he does not represent the insured. The insured is not held responsible for improper acts of the agent. Legal responsibility for the proper performance of the agent's duties rests with the insurance company. Nevertheless, the agent makes an analysis of the prospect's needs for the purchase of insurance similar to the analysis made by a broker. The latter does not represent any insurance company. Whenever he has to obtain a policy for a client, he communicates with the offices of the various companies which issue such contracts and tries to induce one of these companies to issue the required insurance coverage. If the broker obtains a policy, the insured must remit a premium, usually to the broker. The broker is reimbursed by a commission from the insurance company which has issued the policy. It must be remembered that the broker is not appointed to represent any specific insurance company. Therefore, in most instances the acts of the broker do not bind the insurance company, but bind the insured.

Every purchaser of insurance should examine each policy when it is received from the agent or the broker. It is incumbent upon him to read the policy and to note the contents. He will generally be held responsible for all obligations he has assumed as stated in the policy. If there is any misstatement in the policy and a loss occurs at a later period, he may not be able to collect as a result of the misstatement.

He should have read his policy when it was received. In addition, there are four important considerations that the insured should decide upon before accepting a policy from an insurance company and paying the premium. These are: (1) Is the company admitted to the state? (2) What is the capital and surplus of the company? (3) What is the claim service record of the company? (4) What inspection service does the company offer?

It is generally inadvisable to purchase insurance in a company which is not admitted to the state in which the assured is doing business. In case of loss, the assured may find it necessary to go to the state in which the company was organized in order to prove a claim, thus causing unnecessary expense. There should be sufficient capital and surplus in possession of the company to satisfy the assured that it will meet its outstanding claims. The value of the assured's contract will depend upon the company's claim settlement policy. The past history of prompt and just settlement of claims is an important factor in the determination of the insurance company's value to the insured. Many forms of insurance rates depend upon the condition of the insured's plant. These rates can be reduced by inspection of the plant by the insurance company; therefore, the person or corporation placing insurance on a plant should be certain to choose a company which will give adequate inspection service.

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Questions for Study and Review

1. Name at least twenty risks to which a business may be subject.
2. Discuss two methods of assuming risks.
3. What constitutes an insurable interest?
4. When is an insurance contract legally in force?
5. How may insurance contracts be terminated?
6. What supervision has the state over insurance companies?
7. Name six branches of the insurance business. What kinds of protection are afforded by each?
8. Explain four types of life insurance contracts.
9. What is business life insurance?
10. For what purpose are life insurance trusts created?
11. List the essential clauses in the standard fire insurance policy.
12. What is meant by *contribution* with reference to the distribution of a risk among several companies?
13. What is coinsurance?
14. What is rain insurance?
15. Name and explain the principal branches of casualty insurance.
16. Who is required to carry workmen's compensation insurance?
17. How does the marine insurance policy differ from the common run of insurance contracts?

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18. What is a fidelity bond?
19. What is the purpose of title insurance?
20. Contrast the insurance agent and broker.
21. What four matters should be considered before the insured accepts a policy from any company and pays the premium?

Problems

1. Mr. Anderson owned a filling station facing a summer resort hotel. His strategic location enabled him to do an excellent volume of business. Fearing that the hotel would burn, he purchased a fire insurance policy on the hotel building for \$5,000. Two months later, there was a fire and the hotel was completely destroyed. What are Mr. Anderson's rights?

2. Mr. Barton bought a \$10,000 ordinary life policy dated January 1, 1925. What are the beneficiary's rights under the following conditions:

(a) He paid only one annual premium and died on January 18, 1926.

(b) He misrepresented important facts in order to obtain the policy, but paid all premiums as they became due and died on January 1, 1930.

(c) He paid premiums for 10 years, but failed to pay the eleventh premium and died three months after the grace period.

3. Messrs. Chandler and Dodge, partners in a wholesale produce business, have invested \$50,000 each in the business, which represents practically all of their personal assets. Outline an arrangement whereby the survivor will be able to continue the business without financial embarrassment and without admitting the heirs of the deceased into the business.

4. Mr. Andrews bought a \$10,000 fire insurance policy from the Bee Company covering his building. Discuss his rights under the following circumstances:

(a) He waited several weeks before notifying the insurance company that he suffered a fire loss.

(b) A boiler exploded and caused \$500 damage.

(c) He also had \$5,000 insurance on the same building with the C Insurance Company, and a fire caused \$600 damage.

5. Mr. Atkins bought a \$50,000 fire insurance policy on his apartment house. The policy was subject to the 80% coinsurance

clause. What will be the liability of the insurance company for the following losses:

(a) The building had a cash value of \$60,000 at the time of the fire, and the damage was \$4,000.

(b) The building had a cash value of \$125,000 at the time of the fire and the damage was \$4,000.

(c) The building had a cash value of \$60,000 at the time of the fire and there was a total loss.

(d) The building had a cash value of \$125,000 at the time of the fire and the damage was \$50,000.

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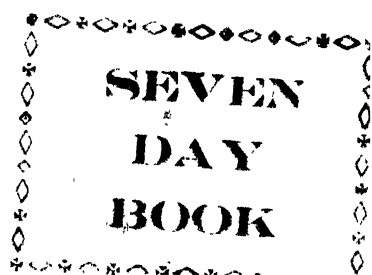
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