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CORPORATION FINANCE

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CORPORATION FINANCE

by

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Professor of Commerce in the University of Toronto

TORONTO
THE MACMILLAN COMPANY
OF CANADA LIMITED
1949

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by

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PREFACE

The first five chapters of this book were published as a booklet at the end of 1945.

My thanks are due to Mr. R. E. V. Anderson, Mr. J. K. Crawford and Professor J. E. Smyth for their kindness in criticizing various chapters of this book; the remaining blemishes are attributable to me alone. I also offer thanks to Mr. F. P. Morrissey for valuable help in preparing the index.

C. A. A.

University of Toronto,
February, 1947.

CONTENTS

PREFACE - - - - - - - - - - - v

CHAPTER		PAGE
I	FORMS OF BUSINESS ORGANIZATION - - -	1
II	FORMATION AND CONTROL OF COMPANIES -	9
III	SHARES - - - - - - - - - -	20
IV	BORROWING—BONDS - - - - - -	37
V	FINANCIAL STRUCTURE - - - - -	55
VI	THE CAPITAL MARKET - - - - -	65
VII	THE STOCK MARKET - - - - - -	80
VIII	MANAGEMENT OF FUNDS - - - - -	94
IX	SCALE OF OPERATIONS - - - - -	111
X	COMBINATION AND MONOPOLY - - -	125
XI	REORGANIZATION AND LIQUIDATION - -	144
XII	SUMMING UP - - - - - - - -	158

APPENDICES

A	APPLICATION FOR INCORPORATION OF A COMPANY UNDER THE COMPANIES ACT, 1934 -	180
B	COPY OF A REPRESENTATIVE PROXY FORM -	184
C	EXTRACT FROM TRUST AGREEMENT IN CONNECTION WITH BOND ISSUE OF THE CANADIAN PACIFIC RAILWAY - - - - - - -	186
D	PROFITS AND DIVIDENDS - - - - -	187
E	NOTES ON DEPRECIATION - - - - -	217
F	DOMINION TEXTILE COMPANY - - -	226
G	REORGANIZATION OF WINNIPEG ELECTRIC COMPANY - - - - - - - - -	233

SUGGESTED READING - - - - - - - - - 238

INDEX - - - - - - - - - - - - 245

CORPORATION FINANCE

CHAPTER I

Forms of Business Organization

Sole Trader

The corporation is the most important form of business organization from the point of view of capital investment and production, and its relative importance has increased rapidly during the past twenty years. Much that can be said of corporation finance is applicable to other forms of business; an understanding of the main differences between the various forms makes it easy to see when the application can be made freely and when modifications are required.

The sole trader, the man who owns and usually manages his own business, with or without the help of employees, was the first form of business organization, and is still the commonest as far as the number of units is concerned. A very large number of retailers, farmers and men and women in various professions carry on business as sole traders. The capital of the business is their own; the management of the business is in their hands or is subject to absolute control by them; the profits of the business are theirs. As a natural corollary, the sole trader bears full responsibility for what is done by the business and suffers the full extent of the losses of the business.

The business and private relationships of the sole trader may be separated by him for his own convenience, but his business and private resources cannot be separated: his private debts and his business debts have an

equal claim on the whole of his resources, for he is but one individual.

This form of business organization is subject to a minimum of regulation by law. Regulation of trade practices and of prices have recently reduced the freedom of the sole trader, but he is not subject to any regulation from which the other chief forms of business are immune. There are some professions in which it is obviously desirable that the members should practise as sole traders, doing in person the important professional work. For instance, the personal skill of a surgeon is the basis for his business, and he cannot satisfactorily carry on a specialist's practice except as a sole trader.

Although some sole traders have built up enormous businesses, involving very large capital and employing many workers, the size of the business is usually limited by the amount of capital one man possesses, or can command without parting with a share of the profits or management. A business run by a sole trader has no certainty of continuity: death or prolonged illness may destroy the organization, or it may pass into the hands of successors who have neither the tastes nor abilities of the former owner. One of the reasons why so many small business men have ceased to operate as sole traders, and have formed companies, is to make continuity easier on their death or retirement. Other businesses have become companies because the payment of succession duty has made it impossible for the new owner to carry on business without the introduction of new capital on a scale so large as to require a share of management rights to go with it.

Partnership

Partnership is defined as the relation which subsists between persons carrying on business in common with a

view to profit. In the ordinary course of the partnership business each partner is the agent of all the partners, and they are bound by his actions. Each partner is liable for the whole of the debts of the firm to the full extent of his separate and private estate, and his share in the partnership is available for the satisfaction of his private debts. The outside world deals with partners as individuals acting jointly under a single name, and only in the event of bankruptcy of the partners does the outside world need to draw any distinction between the individuals forming the partnership and the partnership firm.

The partners may draw up any agreement they wish for the regulation of their affairs between themselves; they are subject to the Partnership Act (provincial) which, in general, makes provision only for the regulation of matters not made the subject of an agreement (written or implicit in their conduct) between the partners. The registration of partnerships is required by the provinces, and this enables anyone contemplating doing business with a firm to discover the identity of the individuals who comprise it. A partnership agreement may be for a fixed period or may terminate at will. A change in the membership of the firm can be made only by the unanimous consent of the partners, and bankruptcy or death of a partner terminates the partnership.

Compared with the sole trader, a partnership draws capital from more sources; the management is less concentrated; continuity is more easily attained, for, in spite of the technical dissolution of the firm on the death of a partner, a new firm may be readily arranged. A large measure of mutual trust between the partners, and a carefully worded agreement, may prevent disputes, which are not uncommon between partners; they lead to inefficiency at the best and disaster at the worst. Those doing business with a partnership have the satisfaction

of knowing that the private estates of the various partners are liable for their claims; the credit of a partnership depends largely on the credit of the individual partners rather than upon the past record or future prospects of the firm.

A sleeping partner is one who takes no active part in the management of the business; he is often a partner who has retired from active work and who is gradually withdrawing his capital from the firm. He is equally liable with the other partners to outside parties.

Limited Partnership

A limited partner is one who subscribes, in cash, a fixed sum of money for the duration of the partnership; his liability is limited to this sum. He must not create the impression of being a general partner by taking an active part in the management of the firm or by allowing his name to be part of the name under which the firm operates. A limited partnership must include at least one general partner whose liability is unlimited, and it must be registered with the provinces in which it operates. This form of organization is not very common, as the private limited company, discussed later, fulfils the same functions effectively.

Limited Company or Corporation

Most of the large businesses are now organized as limited companies. A limited company is given, by law, an individuality quite distinct from those who contribute towards its capital and management; its continuance as a business does not depend on the life, solvency or whim of any of its members.

The development of the limited company has introduced a marked change into business life. Aided by the

fact that many companies operate on a much larger scale than most sole proprietors and partnerships, the limited company has frequently become entirely impersonal in its relations with employees; in some companies there has been a tendency for the management to take the legalistic attitude that it is only the representative of the company, and thus to avoid personal responsibility for some of its actions.

The liability of the members or shareholders of a company is limited to the amount which, at the time the shares are issued, they subscribe or promise to subscribe to the capital;[1] the shares are transferable, and if the full amount promised by the original holder of a share has been paid, no liability attaches to any subsequent holder of that share. The management is in the hands of at least three directors, elected by the shareholders.

A limited company may come into existence in various ways: (1) The dominion and the provinces have each passed a Companies Act under which application for the incorporation of a company may be made; such a company is subject to regulation by the provisions of the act under which it is incorporated. (2) Special acts have been passed to regulate certain types of companies. Companies obtaining a charter under one of these acts are subject to the provisions of that act and to general provisions contained in Part III of the Companies Act.[2] (3) An act may be passed for the specific purpose of incorporating a company. Such a company is subject to the provisions of its own particular act, and also to the general provisions contained in a separate part of the Companies Act.[3]

[1] Section 125 of the Bank Act provides for "double" liability of shareholders if a bank becomes insolvent: the double liability is now limited to a proportion of the authorized note issue of the bank equivalent to the proportion of the share capital owned by the shareholder.

[2] This does not apply to banks and railways.

[3] This does not apply to banks and railways.

The limited company is well suited to carry on businesses in which large capital is required or in which permanency is essential. Large amounts of capital are required, for instance, for efficient production in certain engineering and chemical industries, and for the distribution of public utility services; and insurance, banking and public utilities normally require a degree of permanence not available under operation by a sole trader or a partnership.

The owner of small or large sums of capital is enabled, through the limited company, to participate in ownership, with limited liability and without the daily cares of management, and to obtain diversification of risk very easily. Capable management not possessed of capital may be able to find suitable employment with a company; capital and business ability need not coincide in one person to ensure successful initiation and management of a company. However, the limited company also presents the dangers of irresponsible or fraudulent management by those whose personal stake in the capital is negligible.

Certain professions (e.g., doctors, lawyers, chartered accountants) are precluded, by law or by their charters, from organization as limited companies, and can be practised only by sole traders or partnerships. Limited liability is closed to these professions, which are usually those which require qualifications in training and skill which are individual. Stockbrokers are prevented by many stock exchanges from operating as limited companies, the intention being to maintain a sense of personal liability for the funds of clients.

Private Limited Companies

Any business which contemplates entering into a contract with a limited company is warned of the form of

organization by the word Limited (or its abbreviation, Ltd.) in the name of the company. The regulations of the Companies Act have, however, been largely for the protection of the shareholders. If a company has only a few shareholders the need for their protection is very much reduced, and the protection can be obtained without the publicity required for the protection of a large number of shareholders. The Companies Act provides for the incorporation of private companies, which are free from certain regulations and publicity; such companies must limit the number of shareholders to fifty[4] (which means that the transfer of shares is restricted), and must not issue any invitation to the public to subscribe to shares or bonds.

Many small businesses, previously operated by sole traders or partnerships, have become private limited companies, combining the advantage of limited liability with the privacy of partnership. A certain number of very large businesses, particularly family businesses and Canadian subsidiaries of American or British companies, have also been incorporated as private companies and their freedom from publicity has probably been detrimental to the general interest, for the operations of large companies are of importance to many classes of the community, other than shareholders: employees, government departments, economists, etc.

Mining Syndicates

For a long time mining "syndicates" were formed for the purpose of exploration and testing claims. These organizations issued "shares" or units which were transferred from one holder to another; they were not formed under the Companies Act, and escaped the payment of

[4] Excluding employees, or past employees who hold shares which they held when employed by the Company.

fees charged to limited companies. Their position was equivocal, but they were probably partnerships, operating, perhaps, illegally. The Province of Ontario has now made provision for the incorporation of small mining syndicates, at reduced fees.

Incorporation Not For Profit

Charitable, scientific, social, professional, etc. enterprises, formed to carry on organizations without profit, can apply for incorporation as limited companies. They are restricted in their operations, and are free from some of the regulations of the Companies Act.

Government and Municipal Enterprises

Some very important businesses are carried on by governments and municipalities; some are run as departments of government, while others are run by boards or commissions which are, in varying degrees, controlled by or responsible to the government or municipality. Businesses of this type are found mostly in the field of public utilities; they do not have share capital, but frequently have the power to raise funds by the issue of bonds.

CHAPTER II

Formation and Control of Companies

JURISDICTION

The dominion and the nine provinces of Canada have all passed Companies Acts, and some doubt as to the law, and inefficiency in administration, appear to be the inevitable result of this. A company whose objects are purely provincial will probably obtain a charter from the province in which it wishes to operate, for this is usually the cheapest method; but this does not prevent it from carrying on business elsewhere in Canada. A company whose objects are not purely provincial will probably obtain a dominion charter. The provinces have passed Extra-Provincial Companies Acts (or their equivalent) for the purpose of licensing and regulating "foreign" companies; some of the provisions of these acts appear to be of doubtful validity in respect to dominion companies.[1] The references in this text are to the Dominion Act.

In the United States, where a similar multiplicity of Companies Acts is found, some of the States have entered into competition to obtain fees from the incorporation of companies, and this has resulted in a deterioration in legislation and administration. In Canada this competition has not been so noticeable, although a few companies have taken out charters in Prince Edward Island without apparent reason. The Dominion Com-

[1] See Masten and Fraser: *Company Law of Canada*, pp. 24 ff. and 91 ff. A dominion company is subject to the ordinary law of a province in respect of its operations in that province.

panies Act is much stricter than that of some of the provinces.

Application for Incorporation

The application for incorporation must be made by not less than three persons of twenty-one years of age or more, three of whom are named provisional directors. The application must be accompanied by a memorandum of agreement, by which the applicants bind themselves to become incorporated and to subscribe for a specified number of shares (usually one) in the company. The incorporation fee, which is payable in accordance with a tariff varying with the capital, must be sent with the application. The letters patent (or charter) of the company are issued automatically provided the application and memorandum are regular. The forms of the application and the memorandum of agreement are given in Appendix A. The application gives the following information:

1. *Name.* Any name may be chosen for the company provided that it does not so closely resemble that of another business as to lead to confusion, and provided that it is not objectionable. The word Limited or its abbreviation "Ltd." must be the last word of the name.

2. *Purposes.* In earlier days, the purposes for which a company was formed, and the powers granted to it, were restricted, so that a shareholder had some knowledge of the purpose for which his funds were being used. A company now has wide ancillary powers granted to it in twenty-eight sub-sections of the act, including the power to buy shares in other companies and to sell its assets for shares or debentures in another company "which has objects altogether or in part similar to those

of the company". The first sub-section alone grants very wide powers: "to carry on any other business which may seem to the company capable of being conveniently carried on in connection with its business or calculated directly or indirectly to enhance the value of or render profitable any of the company's property or rights". The application for incorporation may ask for restrictions on purposes and powers which will prevent the exercise of these ancillary powers, but the tendency is for promoters to ask for wide rather than narrow powers. The 1935 amendment of the Companies Act added a rather vague restriction: "If any company (a) carries on any business which is not within the scope of the purposes or objects set forth in the letters patent or supplementary letters patent, or (b) exercises or professes to exercise any powers which are not truly ancillary or reasonably incidental to the purposes or objects . . . such company shall be liable to be wound up".

3. *Head Office.* Although the head office or domicile of the company must be stated in the application, the company need not carry on any business from that office.

4. *Capital.* The authorized capital, on which incorporation fees are calculated, is stated in the application. If more than one class of shares is to be authorized, full details of the conditions and rights attached to each class must be stated. The question of capital is dealt with in some detail in Chapter III.

Changes in Letters Patent

Changes may be made in the letters patent issued on application for incorporation. An application for supplementary letters patent must be supported by a by-law sanctioned by at least two-thirds of the votes cast at a

special general meeting of shareholders called for that purpose. Fees have to be paid on application being made for supplementary letters patent.

Directors

As has been seen above, the provisional directors are named in the application for incorporation; they are usually clerks in lawyers' offices, either to save the time of or to protect from accident those who will eventually direct the company. The directors elected at the first general meeting of the company are responsible for the actions of the provisional directors, but the "true" directors may not come into the picture until all hazards are overcome.

In the absence of any contrary provisions in the charter or by-laws, the directors are elected annually, but remaining directors may fill casual vacancies. In actual fact, of course, the first directors are chosen by the promoters, and remain a self-perpetuating body except in most unusual circumstances. The "democratic" election of directors is generally a pure formality.

No one who is not a shareholder in the company may be elected a director, and the by-laws may require the holding of a minimum number of shares, or impose other conditions. A director must hold his "qualifying" shares in his own right, or in trust, or be a director of another company which is a shareholder. An undischarged bankrupt may not be appointed, and bankruptcy disqualifies a director. The by-laws may provide for the disqualification of a director on other grounds (e.g., lunacy). A company must have at least three directors but the by-laws may provide for any larger number.

Personality of Directors

In some companies all the directors take a direct part in the management, but this is unusual; in many companies the active directors are the Managing Director and the President, with the remaining directors being called to regular meetings of the board, which they may or may not attend. In some companies additional active directors are provided by adding departmental heads to the board; in other companies an intermediate body of semi-active directors is provided by the appointment of an executive committee of the board. The active directors are, of course, usually conversant with the affairs of the company and understand its workings, but many directors have little knowledge of the affairs of the companies whose boards they adorn. They may be elected because of their financial or social prestige,[2] because of some influence they may be able to exercise in favour of the company, or on a reciprocal basis.

Some criticism has been expressed of non-active directors.[3] At the time a company is issuing shares it is obviously most undesirable that the public should, by the appearance of a well-known man as a member of the board, be misled into believing that his talent will be devoted to the affairs of the company when no such thing is intended. The argument is probably sound that the sense of responsibility in directors would be strengthened if all were "active".

[2] Notice the large number of directorships held by bank directors, and by members of the Peerage and retired officers of the fighting services in England.

[3] See, for instance: Hartley Withers: *The Business of Finance*, p. 126; H. B. Samuel: *Shareholders' Money*, Ch. V.; C. A. Ashley: "Some Aspects of Corporations", in *Essays in Political Economy* (ed. H. A. Innis), p. 4; *Britain's Industrial Future: the Report of the Liberal Industrial Inquiry*, p. 90.

By-Laws

The by-laws, which govern the domestic control of the company, are usually drawn up by the original directors and presented to a meeting of the original shareholders, who signed the memorandum of agreement, before shares are issued to the general public; in consequence, the by-laws tend to widen rather than to restrict the powers of the directors, and to protect the directors from liabilities and responsibilities. The directors have power (unless specifically denied) to pass, amend or repeal by-laws, but these actions have force only until the next annual general meeting of shareholders, when they may be confirmed or rejected. A special general meeting may be called to confirm by-laws or to change by-laws which the directors have no power to change.

Voting Rights

In earlier days "one vote one share" was a generally accepted principle. Restrictions of various kinds were introduced through charters and by-laws which deprived some classes of shares of voting rights or granted them only in certain circumstances; the extreme of this was reached when the sole rights to vote for directors were attached to a few "management" shares.[4] Since the amendment of the Companies Act in 1935 no shares may be issued without voting rights, but the right to vote may be restricted to preference shares in certain circumstances (e.g., failure to pay preference dividends for a period of time); shares issued before the amendment were not affected. The act provides that changes affecting the relative position of various classes of shares may

[4] Beauharnois Power Corporation Ltd. gave the exclusive right to elect directors to five management shares for a period of ten years.

be made only on the sanction of two-thirds of the votes of the classes of shareholders concerned, cast at a special general meeting; for this type of voting, voting rights could never be withheld.

Proxies

In the absence of any contrary provision in the charter or by-laws votes may be exercised by proxies. Most companies send proxies, made out in favour of officers of the company, with the notices of meetings.[5]

Voting Trusts

A concentration of voting power is sometimes achieved by the creation of a voting trust; the voting rights of the shares concerned are vested in trustees, usually for a period of years or until the happening of some event. In some companies, shares have been issued subject to a voting trust; in other companies,[5] shareholders have voluntarily surrendered their rights in order to participate in a voting trust. Shares which are subject to a voting trust do not lose this characteristic on transfer from one person to another, and when one class of shares contains some shares which are and some which are not subject to a voting trust, they are quoted separately on the Stock Exchange.

This device has been used in some companies for the purpose of strengthening the already strong position of the management, with no intention of bettering in any way the shareholders. In other companies it has been used in order to vest the control of the company temporarily in the hands of those who have introduced new capital into or made loans to the company during a period of finan-

[5] See Appendix B for example of proxy form.

cial stringency.[6] There are very few voting trusts in Canada, and their popularity as a means to retain management within a small group has dwindled generally.

Duties of Directors

The directors appoint the officers of the company and control them. They exercise their functions as a board and not as individuals, but they may appoint committees of directors and delegate functions to those committees. The day-to-day business of the company is conducted by the officers, and the directors naturally exercise their control largely by considering reports from the officers, and they plan for the future with the advice of the officers. The chief executive officer is normally a member of the board of directors, and other principal officers are also frequently members of the board.

The directors are in a fiduciary capacity with respect to the company.[7] If any director has a personal interest in a contract he must disclose that interest to the board, and he must not vote on the contract. Nor must he profit at the expense of the company in daily operations which do not come before the board for consideration. A director is prohibited from speculating, directly or indirectly, in the securities of the company. The Companies Act does not define speculation, but provides that every director shall furnish the secretary, for the information of shareholders at the annual meeting, with a statement, in detail, of his transactions in the company's securities during the year.

[6] Lake St. John Power & Paper Co. Ltd. introduced a voting trust for the protection of bondholders on a reorganization. The trust has now expired. The Great Lakes Paper Company Ltd. issued shares subject to a voting trust in settlement of bonds of a former company, and this trust terminated in April, 1946.

[7] See Berle and Means: *The Modern Corporation and Private Property*, p. 221 ff. for a discussion of this.

Domestic Arrangements

At first sight, and perhaps in original intention, the shareholders of a company exercise control over the company: they are called together each year, and at any other time on requisition by a sufficient number, and can appoint the directors of their choice. Herbert Spencer wrote of companies in 1854: "As devised by Act of Parliament, the administrations of our public companies are almost purely democratic. The representative system is carried out in them with scarcely a check. Shareholders elect their directors, directors their chairman; there is an annual retirement of a certain proportion of the board, giving facilities for superseding them; and by this means, the whole ruling body may be changed in periods varying from three to five years. Yet, not only are the characteristic vices of our political state reproduced in each of these mercantile corporations—some even in intenser degree, — but the very form of government, whilst remaining nominally democratic, is substantially so remodelled as to become a miniature of our national constitution. The direction, ceasing to fulfil its theory as a deliberate body whose members possess like powers, falls under the control of some one member of superior cunning, will, or wealth, to whom the majority become so subordinate, that the decision on every question depends on the course he takes. Proprietors, instead of constantly exercising their franchise, allow it to become on all ordinary occasions a dead letter; retiring directors are so habitually re-elected without opposition, and have so great a power of insuring their own re-election when opposed, that the board becomes practically a close body; and it is only when the misgovernment grows extreme enough to produce a revolutionary agitation among the shareholders that any change can be effected".[8]

[8] Quoted in B.C. Hunt: *The Development of the Business Corporation in England 1800-1867*, p. 135.

The very wide dispersion of shares amongst the public makes attendance at shareholders' meetings of the vast majority of shareholders quite impossible, with the result that a comparatively small proportion of shares closely held can control a company at all ordinary times. Thus the control of a company is normally determined in the first place by the promoters, and later by the executive directors. A change is less likely to result directly from mismanagement, as suggested by Spencer, than from a rival group wishing to displace the directors (not always for the benefit which will accrue to the company), or as a result of a reorganization of the company requiring the introduction of new capital. Occasionally a rival group will secretly buy shares in a company until it thinks it is strong enough to offer battle to the existing management group; an expensive struggle for proxies will then take place, with the management in the strong position of being able, apparently, to use the funds of the company in printed canvasses for proxies; personal canvassing may also be undertaken on a large scale. The shareholders as a body have to choose between the two rival groups or remain neutral and await the outcome.[9]

Protection of Minorities

The act confers very wide powers on the directors, unless specific limitations are included in the charter or by-laws, and they cannot be removed if elected for a definite period. The tendency of the Courts has been to leave the affairs of companies to majority rule, and not to support a minority unless fraud, or actions unduly favouring one class of shareholders against another, can

[9] McColl Frontenac Oil Co. Ltd. was the subject of a proxy battle in 1938 which resulted in a substantial change in the management group. Canadian Car and Foundry Co. Ltd. was fought for in 1945, when the management won, but with no great credit to itself.

be shown. Shareholders holding one-tenth of the shares entitled to vote can requisition a meeting of shareholders, and the Secretary of State may, on the application of shareholders, appoint inspectors to investigate and report on the affairs of a company, but the expenses have to be defrayed by the applicants unless charged to the company by the Secretary of State.

Shareholders have the right to inspect and copy the register of shareholders, but to use this right as a means to canvassing for proxies is too expensive a procedure for the ordinary shareholder to use. The experience of minority shareholders suggests that their best course of action may be to dispose of their shares at the earliest possible moment, rather than to enter on a struggle in which they are placed at a disadvantage at every turn.

Public Interest

The protection of shareholders and of the public which is to be found in England through the work of the Registrar of Companies is greater than that offered in Canada by the Secretary of State. The influence of limited companies upon the whole economy of the country is now so profound that they can no longer safely be left in the ambiguous position of being "persons" but without personal responsibilities; their organization and control can no longer safely be left as a purely domestic matter to be settled by the collection of proxies in sufficient numbers to give a bare majority at a meeting.

CHAPTER III

Shares

Capital

In the application for incorporation and the letters patent, capital means authorized capital: the number of shares of one or more classes which the company may issue. The conditions and rights attached to each class of shares are stated in the letters patent. The term "capital of a company" more frequently means the issued capital: that is, the number of shares actually in the hands of shareholders; or the dollar amount appearing against those shares in the books of the company. The owner of a share possesses a proportionate part of the rights of the shareholders as a whole to the property of the company; the shareholders, as a body, are the owners of the company. The shareholders do not, however, own the assets of the company. The company is a legal entity distinct from the shareholders; it has power over its assets and is responsible for its liabilities, and there is no contractual relationship between the shareholders and those with whom the company transacts business. The ownership of a share is evidenced *prima facie* by a share certificate, final proof being found in the share register and transfer register of the company.

Issuance of Shares

When the company is organized, the directors proceed to issue shares in accordance with the provisions of

the by-laws, and shares may be issued from time to time up to the number authorized by the letters patent. The actual methods by which shares are issued will be discussed later. An application for shares constitutes an offer, which is made into a binding contract by the allotment of shares by the directors, at which time the shareholders become liable for payment to the company of the amount they have agreed to pay. This amount may be paid in full at the time of application, or may be payable over a period of time as "called" by the directors. Sometimes the calls are spread over a considerable period, as the company may not need all the funds immediately, and shareholders may be attracted by this arrangement. Part of the capital may remain uncalled for a long time, but this is now unusual, if not unknown, in Canada.

Shares may be issued not only for cash subscriptions, but in payment for assets which the company acquires, or for services rendered in the organization of the company.

Types of Shares

The rights and conditions attached to each class of shares are stated in the letters patent and by-laws. The main division between types of shares is between preference and common, or ordinary, shares, but there are endless variations within these main groups. The actual name given to any particular class of shares does not necessarily describe it fully, nor does it relate it accurately to any class of shares bearing a similar name in another company. All the shares of one class within a company, however, have equal rights and identical conditions attached to them. The importance of careful wording of the rights is evidenced by the cases brought to the courts for judgment.

(*a*) *Preference Shares.* Preference shares may enjoy many different forms of preference, but no form of preference follows from the naming of the shares: each preference must be explicitly stated. Probably all preference shares have a preference as to the payment of dividends. The payment of dividends depends normally on profits (present or past) being available; the directors decide whether any dividend shall be declared, and sometimes the by-laws require that the decision to pay the dividend shall be confirmed by the shareholders in general meeting. Usually, if a company has preference shares a dividend of a fixed amount must be declared on the preference shares before any dividend can be declared for that year on any other shares. The amount of the full preference dividend may be expressed as a percentage of the nominal value of the shares, or as so many dollars a share if the shares have no nominal value. A dividend at less than the full amount of the preference dividend may be paid, but the other classes of shares cannot then receive any dividend.

A company may have more than one class of preference shares, ranking one after the other in their preference. For instance, there may be 4% First Preference Shares, 5% Second Preference Shares and 6% Third Preference Shares, all enjoying the right to receive their fixed dividends, in turn, before other shares receive any dividend.

Preference shares may be issued with preference as to capital; that is to say that, if the company is wound up, the preference shares carry a first claim on the assets after the settlement of all claims by creditors. In the absence of any provision to the contrary, all shares rank equally in the division of assets on winding up. The usual provision for preference shares is that they shall receive preference up to a fixed amount; whether they are en-

titled to anything beyond that fixed amount depends on the wording of the regulations.

(*b*) *Cumulative Preference Shares.* Instead of carrying a right to preferential payment of a fixed dividend in any one year, shares (called Cumulative Preference Shares) may have a preferential right to the payment of a fixed dividend for every year from the date of their issue. If no dividend, or less than the full dividend, has been paid on these shares in any year in the past, this deficiency must be made up, and the present year's dividend be paid, before shares ranking below them receive any dividend for that year.

Most of the preference shares of Canadian companies are cumulative. The cumulative rights prevent the directors from withholding preference dividends from time to time, even when profits are available and payment of preference dividends could well be made, in order that common shares may receive a higher proportion of the profits when dividends are paid in a later year. In the absence of proof of fraud by the directors, it seems unlikely that the Courts would interfere with the discretion of the directors in refraining from declaring dividends. In the Unites States, however, the Court forced the Ford Motor Company to pay dividends against the wish of the directors.[1]

(*c*) *Participating Preference Shares.* The interest of some classes of preference shares in the profits of the company is not restricted to a fixed dividend, simple or cumulative, but may include a participation in the further distribution of profits. Usually this participation operates only after dividends of a certain fixed amount have been paid on all the other shares. For instance, if a

[1] H. G. Guthmann and H. E. Dougall: *Corporate Financial Policy*, p. 533.

company has issued 6% Participating Preference Shares and Common Shares, it may be provided that after the 6% has been paid on the participating preference shares, up to $5 a share may be paid on the common shares, and that if any further dividends are declared the amount paid must be divided between the two classes of shares in a certain fixed proportion.

The need for careful wording of the provisions is shown by the experience of Steel Company of Canada Ltd. The company issued 7% Cumulative Participating Preference Shares and Common Shares, and the letters patent provided that, after the common shares had received dividends equal to those paid on the preference shares, the preference shares should participate rateably with the common shares in any further distributions. "The regular cumulative 7 per cent dividend on the preferred shares had been paid every year but in some years the common shareholders had received a dividend of less than 7 per cent; the directors declared a dividend of 8 per cent on both the preferred and common shares and it was held that the provisions of the letters patent prevented the payment of a dividend greater than 7 per cent on the preferred shares until such time as the total dividends paid on the common shares since the incorporation of the company should equal, as to the rate thereof, that theretofore paid on the preferred shares."[2]

(*d*) *Convertible Shares.* Preference shares are sometimes issued which carry the right of conversion into common shares, in a fixed proportion of so many common shares for each preference share; such conversion rights may be subject to a time limit. While convertible preference shares are entitled to preference dividends, they carry with them a speculative element in that the

[2] Masten and Fraser: *Company Law of Canada*, p. 322.

holders may, by exercising their rights, join with the common shareholders in the enjoyment of great prosperity should the company achieve this. They differ from participating preference shares in that, once the conversion rights have been exercised, all preference disappears. A company that issues convertible preference shares must maintain unissued but authorized common shares in sufficient numbers to satisfy any claims for conversion that may be made. The Companies Act also allows for the issue of common shares which may be converted into preference shares.

(*e*) *Guaranteed Preference Shares.* As the declaration of dividends depends in the first place upon profits and in the second place upon funds being available for distribution, a company cannot give any guarantee that it will pay preference dividends. It can, however, enter into a contract with another company which guarantees the payment of those dividends. Guaranteed preference shares are, therefore, shares the payment of dividends on which is guaranteed by some other company; such a guarantee has usually arisen at a time of reorganization by, or some form of consolidation with, another company. The guarantee is valid only if the company giving it receives consideration from the original shareholders entitled to it.

(*f*) *Common (or Ordinary) Shares.* If only one class of shares is issued by a company, these shares are usually known as common shares. Further, if a company has preference shares, then the shares of the class which has no preference attached to it are known as common shares. In some companies even common shares may be subdivided into Class A and Class B, some form of preference being given to the one class over the other.

(*g*) *Deferred Shares.* In England some companies

have issued deferred shares; as has Dominion Oilcloth and Linoleum Co. in Canada. Deferred shares receive no dividend until a fixed dividend has been paid on the common shares; they are usually small in number and many bring in a very high yield if the company is particularly successful. They may be issued appropriately in payment for patent rights or services of organizers when a high value is claimed for these, but is not proved at the time of payment.

(*h*) *Management Shares.* In the past some companies have issued shares, usually of a very limited number, conferring on the holders very wide powers of management, including the exclusive right to the election of directors.[3]

Such shares may no longer be issued by companies under the Dominion Companies Act.

(*i*) *Redeemable Shares.* Although a company cannot purchase its own shares, the Companies Act allows the issue of redeemable preference shares.[4] The redemption may be at the option of the company or may be mandatory if certain conditions are fulfilled. The exact regulations are laid down in the letters patent or in the by-laws, and usually provide for the redemption price to be higher than the nominal value, so that the shareholders obtain some compensation for their loss of an investment in a company which is so flourishing as to be able to redeem some of its shares. The by-laws of some companies require them to set aside a proportion of their profits, for the purpose of redeeming preference shares, before any dividend may be paid on common shares. If the preference shares are issued without any provision for their redemption, the company may redeem them only with the consent of the holders.

[3] See Chapter II, under "Voting Rights".
[4] No-par shares cannot be redeemable in dominion companies.

The Companies Act provides that preference shares may not be redeemed if there are arrears of cumulative dividends attached to them, and, for the protection of creditors, requires that the redemption must not result in an impairment of the capital, but must be made only by payments out of accumulated profits which are available as liquid assets. This last provision does not apply to the redemption of shares out of funds provided by the issue of new securities by the company.

No-Par Shares

Until comparatively recently each share in a company had a nominal "value", and each subscriber to a share paid at least that nominal amount for it. An undue importance was attached to the nominal value by some people who were, apparently, persuaded that if they could acquire a share "of $100" for less than that amount they were making a bargain purchase. All that was really indicated by the hundred dollars was that this amount had been subscribed to the company by the original holder; it had nothing to do with the "actual" value of the share. A considerable amount of fraud had taken place at the expense of the financially illiterate, and Companies Acts in many States were amended to permit the issue of shares without nominal or par value. The Dominion Companies Act introduced no-par shares in 1917. The emphasis was removed from the minimum amount paid for the share, and assurances were given by those favouring the change that attention would thus be directed only to the fact that each share was one out of the total number issued, and carried with it a proportionate interest in the company. The change was, ostensibly, for the protection of investors.

1. *Value of a Share.* If a company starts business by issuing, for cash, shares with a nominal value of $100

each, no sooner does it enter into transactions with the outside world than the value of the shares can be expressed in two other ways: market value and book value. The market value is influenced by the success of the company's operations and estimates of its prospects of earning profits in the future, and is seldom likely to coincide with a nominal value of $100. (The earning power value —the capitalization of average profits at current interest rates—will vary from the market value.) The book value of each share is the proportion represented by that share of the excess of the book value of the assets over the book amount of the liabilities of the company, and this value changes with almost every transaction carried out by the company; only by accident will it be $100 at any particular time.

A share of no-par value is issued for a certain amount in cash,[5] but that amount is not attached to it, except in memory for a short time; as will be seen later, these shares may be issued at different prices at different times, so that the issue price at any particular time may soon cease to have any significance. These shares also have, of course, their market value and their book value. If shares of no-par value have any preference as to capital repayment over any other shares issued by a company, the amount to be paid to the shareholders on dissolution of the company must be stated in the letters patent.[6] Preference shares with nominal value usually receive the nominal value, and that alone, on dissolution of the company.

2. *Advantages Claimed for No-par Shares.* Under the Dominion Companies Act shares with a nominal value cannot (unless shares of a mining company) be

[5] Or for assets or services against which a dollar amount is placed.

[6] Dominion companies cannot issue such shares.

issued at a discount; that is, for a consideration less than the nominal value. A company whose shares have a nominal value, and which has issued only part of its authorized capital, may wish to obtain additional funds by issuing more capital, but it will be unable to do this if the shares already issued are quoted on the market at less than the nominal value. This is particularly likely to happen after a period of depression, or unsuccessful operation, when prospects become brighter but liquid funds are lacking. Such a company can proceed only by reducing the nominal value of its shares by special resolution of the shareholders applying for supplementary letters patent, as described later. The directors of a company whose shares have a nominal value may be tempted to try to cause a rise in the market value of the shares to avoid the difficulties with which they are faced. A company with no-par shares, however, can issue any part of its authorized capital, which has not yet been issued, at any price, and if it offers shares for slightly less than the current market price, it has every prospect of disposing of them.

Of all the advantages claimed by various writers for no-par shares, this is the only one which has any sound basis; a careful examination of the others will invariably show that the real advantage is not necessarily to the shareholders or to the company, but to the directors or management, whose freedom of action is vastly increased, without adequate safeguards for other interests. The English Companies Act of 1929 overcame the difficulty by allowing the issue of shares at a discount on legitimate occasions, and subject to proper regulation.[7]

The changes made in Companies Acts in the United States of America undoubtedly influenced the act in Can-

[7] 19 and 20 Geo. 5, Ch. 23, Section 47.

ada and resulted in a loosening of restrictions. Requests for changes in the act were supported by the following statements: "What we need in Canada is capital, and we cannot get capital unless you give it what it demands . . . One does not like to see what they think is the Dominion Companies Act lagging behind the recognized improvements in the corporate structure that you find in other jurisdictions."[8] The opposite point of view was also expressed: "I would be inclined to think that in the long run the soundest corporation law would draw the best, I think, the greatest amount of capital."[9]

3. *Disadvantages of No-par Shares.* The main objection to the provisions of the Companies Act is that it allows so large a measure of freedom to the directors as to invite manipulation by them at the expense of the shareholders; and it arises from one subsection dealing with the issue of shares.

(a) Price of Issue. In the absence of anything to the contrary in the letters patent or the by-laws of the company, the directors may issue no-par shares from time to time for any consideration they choose; the letters patent and by-laws usually leave this power in the hands of the directors. Since the amendment of the act in 1935, the directors have been required to determine by express resolution the fair equivalent in cash of any consideration other than cash for which shares with a nominal value are issued, but no such protection is given on the issue of no-par shares for cash or for any other consideration. Shareholders have no protection unless they can prove fraud, and information may be hard to obtain, and proof of fraud expensive and difficult. The issue of shares

[8] Proceedings of House of Commons Select Standing Committee on Banking and Commerce, 1930. No. 1 Minutes of Proceedings and Evidence, p. 6.

[9] *Ibid*, p. 27.

with identical rights at different prices to different people is grossly unfair unless an equivalent change has taken place in the prospects of the company, but there is no easy way of discovering whether different prices have been charged.

(b) Amount to be Considered as Capital. When a company issues a share with a nominal value, the nominal value is credited to the capital account, and the book amount of capital attributable to that share remains unchanged as long as the share is outstanding. Such a company cannot pay dividends which will impair this capital, but can pay dividends only to the extent that it has earned profits. A company which issues shares of no-par value can, by resolution of the directors and provided that the conditions of issue so state, set aside up to 25% of the consideration received for the shares as "distributable surplus". It follows that such a company may pay dividends without having earned any profit; and use part of the proceeds of an issue of no-par common shares to maintain dividend payments on preference shares. This is obviously contrary to the whole spirit of company law and is a direct invitation to fraudulent practices by the management, under cover of the law. "Contrary to the generally accepted conclusion, from the standpoint of the individual shareholder, shares without par value, under the present laws, are clearly disadvantageous."[10] "The last bar to swindle has been lowered."[11]

Simplification of Capital Structure

Examples are given in Chapter V of the capital of companies, and from these it will be seen that some companies have only one class of shares whereas other com-

[10] C. B. Robbins: *No-Par Stock*, p. 94.

[11] *Ibid*, p. 13.

panies have several classes with complex conditions attached to them. When a company is first formed, the promoters wish to appeal to the investing public as a whole, and may decide to have several classes of shares. During the lifetime of a company, it may need to raise additional capital in an unfavourable market, and this may lead it to offer additional inducements and preferences to investors by creating a new class of shares. Some of the capital structures are so rococo in design that it is difficult to believe that they were imposed by the conditions of the capital market; they appear rather to be the artistic release of emotion on the part of investment dealers. The simpler the capital structure, the more difficult is it for promoters and managers to indulge in nefarious schemes at the expense of shareholders; in business affairs, purity of line is to be preferred to florid elaboration of detail.

Share Certificates

Every shareholder is entitled to a share certificate which is *prima facie* evidence of title to the number of shares stated on it. If there is more than one class of shares, the certificate states the rights and conditions attached to the shares to which it refers. When shares are sold, the purchaser does not become a shareholder until the transfer is registered by the company or its agents; a new certificate is issued when registration is effected. Share certificates are however, frequently endorsed in blank when the shares are sold, and may change hands several times before a new shareholder's name is entered in the endorsement and the certificate sent to the company for registration of the transfer. This practice is recognized by the Companies Acts in respect of shares

listed by a stock exchange.[12] All dividends declared by the company are payable to the shareholders listed in the company's books at a date fixed by the declaration.

Share Warrants

Share warrants are equivalent to bearer share certificates, and are not much used. A company may issue share warrants, for fully paid shares only, if so authorized by its letters patent; it then keeps no register in respect of these shares. Transfer is effected by delivery; dividend coupons are attached to the warrants and are cashed through a bank when a dividend is declared.

Watered Stock

Stock is said to be watered when, at the time shares are issued, the dollar amount of the capital is not represented by the receipt of an equivalent real value of assets; the watering usually takes place now only when a company takes over an existing business and issues shares in payment.[13] The valuation of assets when an existing business is purchased is not easy, particularly when the question of goodwill arises. The over-valuation which may result from an honest and slight mistake is not termed "watering"; that expression is reserved for the excessively sanguine or dishonest valuations which are usually found in periods of prosperity. The watering is caused by excessive profits going to promoters or investment dealers in payments made to them for assets they own, or for services rendered by them. If a company has operated at a loss for some time, the capital will cease to be represented by an equivalent net value of assets, but

[12] See Masten and Fraser, p. 216, for a statement of the law.

[13] Watering of stock may occur in entirely new ventures in times of unbridled speculation: for instance, at the time of the South Sea Bubble.

this does not constitute watering of stock; the water may, however, have been there already.

1. *Overpayment for Assets.* When a company is formed to take over an existing business, the promoters (who may also be investment dealers) usually own the business, or a large proportion of its shares if it is organized as a limited company. An appraisal company is employed to value the assets as a basis for the issue to the public of shares in the new company. The value placed on the assets is far in excess of their book value in the old business, and, during a speculative boom, the public is readily persuaded to purchase shares at a price justified only by the inflated values of the assets; on the breaking of the boom it becomes apparent that these values are excessive and the discovery is made that the promoters have sold the business to the company at a price far in excess of what they paid for it. This procedure is facilitated by the issue of no-par shares by the new company, although the Dominion Companies Act now makes this more difficult than it was before 1934. If the company survives the break in the boom, it goes through a long process of squeezing out the water by using its profits to write down the value of its assets to a reasonable figure.

2. *Overpayment for Services.* When a new company is formed, the promoters usually receive shares in payment for their services, and payments for inventions and patents are often made in the same way. If the number of shares is excessive stock-watering has, of course, taken place. The introduction of no-par shares has made this type of watering very simple, because the dollar amount put against these shares in the capital account may be far below the market price of the shares, or of the price at which the promoters dispose of them to the public. If the shares had a nominal value the overpayment would

be more easily recognized, and the sale of the shares to the public would have to be at a premium if indirect profits were sought by the promoters. If excessive cash payments are made for services, then the cash must be provided out of the capital subscribed by the public, and the company's treasury suffers directly by this form of watering.

3. *Amalgamation.* Some amalgamations of competing companies, carried out by the creation of a new company, have presented striking examples of stock-watering. In addition to the overpayment for assets and services, special payment has been made to the promoters on account of "goodwill" likely to result from the reduction in competition and from the savings in operating charges through a larger scale of operations. Such companies have sometimes asked for tariff adjustments to enable them to earn a fair return on their inflated capital.

Bonus Shares

The ingenuity of lawyers and financial agents in thinking of new devices to make share issues appear attractive has no end. Whether the investing public needs a constant titillation to interest it in the market is very doubtful; more probably each new method brings with it new opportunities for promoters' profits—or perhaps each new method must be judged on artistic grounds alone as a work of creative genius. Nothing is so likely to appeal to people as the opportunity of obtaining something for nothing; and the appearance of obtaining something for nothing is presumably the reason for the use of bonus stock. A company wishes to issue preference shares and decides that 6% is about the dividend rate which will be attractive; as the shares have a nominal value of $100, they cannot be issued for less than this

amount, so that the real dividend rate cannot be raised slightly by issuing the shares at $99 each; but the company can make them a little more attractive by *giving* a common share of no-par value with each preference share. The company cannot, however, issue any shares without receiving consideration for them, so that the common shares have first to be issued for a consideration to someone else and then put at the company's disposal by him as a gift. If a man is selling assets to a company, he may be satisfied to receive 1,000 shares of no-par value in payment for them; the company suggests that he should receive 2,000 shares and then put 1,000 at the disposition of the directors, to give away to subscribers to preference shares. The allotment to him of more shares than would have satisfied the vendor of the assets, for the sole purpose of defeating the provision of the companies act which forbids the issue of shares at a discount, is *prima facie* fraudulent; it could hardly be carried through without the use of no-par shares. In the unlikely event that the shares allotted to the vendor are the only no-par shares that the company has issued, or intends to issue for some time, no dishonesty could be suggested.

CHAPTER IV

Borrowing—Bonds

Sources of Funds

The first funds available to a company are, of course, those provided by the issue of its shares; the shareholders are interested in the company as proprietors. During the life of the company its funds may be increased by the retention or ploughing in of profits earned in operation, and in recent years this has been the most important source of funds for expansion. The effect of retaining profits is to deprive the shareholders of dividends which might otherwise be paid, and to increase the amount of their proprietorship. The company can also increase its funds by the issue of additional shares.

In the course of its operations a company will purchase goods or services on credit and will sell goods or services on credit. This ordinary commercial credit is governed largely by the custom of the trade, and, while providing funds for the company also demands the use of funds of the company. The difference between the Accounts Payable and the Accounts Receivable shows to what extent the company is a net receiver or provider of funds.

The only other source of funds that can be tapped by a company is that provided by borrowing. The terms of loans vary greatly: they may be short-term or long-term, and secured or unsecured.

Short-Term Loans

The short-term loans used by companies are usually provided by the commercial banks. The making of loans to their customers, or allowing them to overdraw their accounts, is, of course, one of the chief functions of banks. The conditions on which a bank will make a loan vary according to the past relations between the bank and its customer, the present financial position of the customer, the security available, and the other commitments of the bank. Small advances, for short periods and to reliable customers, are often made without formality and without specific security, but larger loans are made only against security. The constant aim of a bank is to keep its resources "liquid".

The Bank Act provides that a bank may not make loans on the security of real property,[1] but a mortgage of real property may be taken as additional security for a loan. The securities on which a bank may make loans are covered by sections 75, 79, and 83 to 90 of the act, and consist of goods or negotiable instruments which will be realized in cash in the ordinary course of business, or which have a cash market. Section 88 provides that property similar to that described in the loan agreement, which may come into the possession of the borrower after the date of the agreement, but before the security is released, shall form part of the security; and when loans are made against seed grain, fertilizer and binder twine, the crops shall be part of the security. The general effect of these provisions is that the banks are able to provide working capital for a business and yet keep their loans liquid, without upsetting the ordinary flow of goods.

The liquidity of an individual bank loan is not, however, the same thing as the liquidity of all bank loans, or

[1] See Farm Improvement Loans Act, Sec. 7 for exception.

of large sections of them. A bank may make loans against a particular commodity and find that the loans turn out to be bad, not because one merchant fails, but because the bottom falls out of the market in that commodity; the bank is then left with a security which has lost its liquidity or which can be liquidated only at considerable loss. The same thing is true of loans against bonds and shares. If the prime purpose of the banks is to safeguard their depositors by keeping their assets liquid under existing law and banking practice, then they must take care to diversify the types of loans they make and be prepared day by day, if not hour by hour, to liquidate the securities they hold. Unless they have been very wise in their actions during a period of rising activity, their actions on the break of a boom are almost certain to accentuate the collapse. The insistence of the Bank Act on preventing banks from making loans on the security of fixed assets such as land, buildings and equipment, has some element of unreality in it, for the banks may make loans to manufacturers against goods which will become fixed assets in due course; thus the banks may, in fact, be facilitating the expansion of fixed assets indirectly when, from the point of view of the economy as a whole, it might be preferable for their control to be direct. In addition the banks may make advances against bonds and shares issued by a company for the express purpose of acquiring cash to purchase fixed assets. The Industrial Development Bank has been set up for the purpose of aiding industrial development directly. It may make loans to those engaged in, or about to engage in, an industrial enterprise, and may underwrite industrial bond and share issues.[2]

[2] Industrial Development Bank Act. Sect. 15.

Mortgage of Assets

Security for a loan frequently takes the form of a mortgage of assets. A mortgage is a deed by which the title to the asset is transferred to the mortgagee (the lender), who binds himself to transfer the title back to the mortgagor (the borrower) when the latter has fulfilled his obligations under the deed. The deed makes provision for the payment of interest and the repayment of capital at specified times; in order to maintain the value of the security, provision is also usually made for the payment of taxes on the assets and for keeping them in repair, and for their insurance. If the mortgagor fails to carry out his obligations, the mortgage may be foreclosed by action of the Court, but until this action is taken, the mortgagor has the right of redemption by carrying out his obligations. The amount of the loan is usually considerably less than the market value of the assets so as to leave a margin of safety to cover expenses and probable fluctuations in value; if this margin is excessive, a second mortgage may be placed on the assets as security for another loan.

A mortgage of land, buildings and equipment refers to specific assets, but a mortgage of inventory (that is of goods which the mortgagor is buying, manufacturing and selling as part of his ordinary business) is usually worded so that it covers the goods currently on hand at any time.[8] The accounts receivable of a business can be assigned as security for a loan, but the same purpose can usually be effected more conveniently by the drawing of bills of exchange on the debtors and discounting them at a bank.

Mortgages are subject to provincial law; the laws of

[8] *Cf.* Sect. 88 of the Bank Act. See above under Short-term Loans. See also below: "After-Acquired Property".

the different provinces are similar, with the exception of some special points in the law of Quebec. Mortgages must be registered with the province and, by examining the registers, prospective creditors can discover very useful information. The directors of a limited company cannot mortgage the assets of the company unless authorized to do so by the by-laws. Companies are required to keep registers of mortgages, available for inspection by the public.

Notes

A note (or promissory note) is a bill of exchange in which the drawer and acceptor are one person. Unsecured loans are usually acknowledged by the issue of a note; this has two advantages from the lender's point of view: a note is negotiable, and it is *prima facie* evidence of the debt. Loans against notes are usually for short terms only, and many of them are secured by a mortgage of assets. If a note is negotiated, that is endorsed and transferred for value, the endorser is liable on the note if the drawer fails to pay it when it falls due. A form of security that is sometimes used in connection with a note is to obtain the endorsement of a reliable man or firm; in this way the lender has the resources of two parties to which he can look for repayment.

Bonds—General

If a business organization wishes to borrow a large amount for a long term, it will usually find that the whole of the loan cannot be obtained from one or two sources. First, because no other organization is likely to have a large sum unemployed at the moment it is required, and secondly, because no one would wish to have very large sums tied up for long periods in one business unless some

control went with the loan. Many people and businesses, however, have funds available for loan, under suitable conditions as to interest payments and repayment of capital, and with suitable security. In order to avoid the trouble and difficulties of dealing separately with each lender, and in order to avoid also the trouble to each lender of examining in detail the terms of the loan and supervising the carrying out of the terms of the trust deed, a tripartite agreement is made. Individuals lend their funds to the organization, which issues bonds to the appropriate amounts; the organization enters into a trust deed with a trustee for the bondholders, mortgaging assets to him in trust for the bondholders; the trustee agrees to act on behalf of the bondholders, supervising the execution of the trust deed and, when necessary, applying the sanctions for which it provides.

The bonds are issued in amounts usually of $100 each, and each bond is in every respect equal to the other bonds of the same issue. The bonds can be sold by the bondholders, and this has the great advantage of allowing short-term investment by bondholders and, at the same time, long term borrowing by the organization issuing the bonds. When planning a bond issue, the organization appoints a trustee[4] likely to command the confidence of prospective bondholders, and its legal advisers draw up a trust deed which is likely to satisfy the trustee and the legal advisers of prospective bondholders.

Bondholders have, normally, no management rights in the business in which they hold bonds unless default has occurred in carrying out the terms of the trust deed and the sanctions allowed to them grant such rights. A bond is a debt of the business, and the interest becomes a debt of the business as soon as it falls due; the liability

[4] In Canada the trustee for bondholders is usually a Trust Company.

for interest payments does not depend in any way upon the earning of profits.[5]

Government bonds are somewhat different from industrial or commercial bonds. No trustee for the bondholders is appointed, no mortgage of assets is given as security, and no sanctions are provided. The government undertakes to pay interest and to repay capital, and the security consists in the probability that the government's income will be sufficient and will be so managed as to allow it to meet its obligations. Although government bonds are an important element in the capital market (i.e., the market for long-term funds), the details connected with them are not part of Corporation Finance. Apart from governments (federal, provincial, municipal and school board) the only important issuers of bonds are limited companies, and corporation bonds are referred to in the following unless the contrary is specifically stated.

Terms of Trust Deed

The trust deed is concerned mainly with the security of the bondholder and usually covers the following points:

1. an accurate description of the property mortgaged and an estimate of its value;
2. a statement of the priority of the charge against the property;
3. the maintenance and insurance of the property;
4. the payment of taxes on the property;
5. the total amount of the issue of bonds authorized;
6. the payment of interest;
7. the repayment of capital, or redemption;
8. the circumstances in which sanctions can be applied; and

[5] Except for Income Bonds discussed later.

9. the method of applying sanctions.

Certain of these points are discussed below.

Security

The security of the bondholders usually consists of a mortgage of specific assets and a general charge over the whole undertaking. The margin of safety between the estimated value of the property mortgaged and the amount of the bond issue should vary in accordance with the probable marketability of the property in the event of default. If, for instance, the property consists of land, buildings and equipment with no uses alternative to the purposes for which the company was formed, a large margin of safety should be allowed; in an extreme case the security consists solely in the probable successful working of the venture. For instance, the assets mortgaged to the bondholders of the Abitibi Power and Paper Company Limited were such that, unless the company or a manager for the bondholders could operate the mills profitably, the security was illusory. On the other hand, the mortgage of land and buildings in an industrial city may offer excellent security because of the many alternative uses to which the property can be put, and consequently the ready available market for them in the event of default.

"After-Acquired Property"

In certain circumstances, a company may wish to float a bond issue which will provide it with funds for various purposes over a period of time, and it may wish to use funds derived from the bond issue at some future time to acquire the assets which will provide part of the security for the bonds. The obvious example is that of a company formed to construct and operate an apartment building or hotel. The company offers bonds on the

security of property which it will acquire after the date of the issue; the funds subscribed are held in trust by the trustee for the bondholders, and he makes payments to the builder of a certain percentage of each of the builder's accounts, certified by the architect. In this way the cash derived from the bond issue comes into the use of the company only in proportion to the value of the security. The capital of the company provides the margin of safety: the difference between the amount of the certified accounts and the amount paid by the trustee.

The plans of expansion of other companies are not as neatly arranged as this, and the company will have power to issue blocks of bonds from time to time up to a fixed percentage of the value of the specific assets mortgaged in the first place; and then for additional amounts, under the supervision of the trustee, up to a percentage of the value of "after-acquired" property. The advantage of this method is that the company pays interest on bonds only to the extent that it needs the funds, and that one bond issue is made to fulfil functions that would otherwise require several issues.

Redemption

The funds for the redemption of bonds can be obtained only from the following sources:

1. a new or refunding issue of bonds;
2. an issue of shares;
3. disposal of part or the whole of the assets; and
4. profits made and retained by the company.

The first two of these sources do not of themselves offer good security to bondholders because, when the time comes for the redemption of the bonds, the capital market may be unfavourable for the issue of new securities, and the earning power of the company may not be such as to inspire confidence. The third of the sources men-

tioned constitutes the last resort of the bondholders, and is not of itself a suitable security to offer to them. The vast majority of bonds are issued under conditions envisaging the earning of profits and the setting aside of an annual amount out of the profits to provide funds for redemption. The setting aside of an annual amount requires in the first place only a charge against the profits, or accumulated surplus, and a credit to a Sinking Fund Reserve. The effect of this entry in the books of the Company is merely to prevent the payment of dividends to this extent; it is only a book entry, and does not denote any physical change in the assets of the company. However, the fact that profits have been retained means that additional funds have become available within the business, and the security of the bondholders may depend on what use is made of these funds. The use to which they are to be put is usually stated in the trust deed; in the possible absence of any such statement it depends on the policy of the directors.

The profits which are set aside may be used for the expansion of the company's activities; although this broadens the security of the bondholders and thus makes a refunding easier (provided the company operates at a profit after expansion, which by no means follows), this is not a satisfactory arrangement for the bondholders for the reason given in the above paragraph. The profits set aside may be used by the company for investment in outside securities (such as government bonds) so that these securities, plus the income on them (invested annually) will provide funds sufficient to redeem the bonds when they fall due. The disadvantages of this arrangement are first, that the interest earned on safe investments is less than the interest paid by the company on its bonds, and secondly, that its success depends on factors entirely outside the control of the company: if the cur-

rent interest rate on gilt-edged securities is higher at the time the securities are sold than at the time they were purchased, their market price will have fallen and the proceeds will be insufficient to redeem the bonds.

The commonest method of dealing with profits set aside for the redemption of bonds, and by far the most satisfactory from the point of view of the bondholder, is for these funds to be used to redeem a portion of the bonds each year or to purchase the company's bonds in the market. The trust deed usually provides that the company shall pay to the trustee for the bondholders a certain sum each year which may be used by the trustee to purchase bonds in the market if the market price is favourable, or, otherwise, to redeem bonds chosen by drawing lots. An arrangement is usually made for the redemption of the bonds drawn to take place at a premium above par, the amount of the premium being reduced every five years so that the final redemption takes place at par. This provides compensation for those bondholders who, intending to purchase a long-term investment, find that a drawing of bonds for redemption has turned their investment into a short-term one, or at any rate shorter than they had contemplated.[6]

In spite of this premium payable on early redemption, considerable hardship and inconvenience may be caused to long-term investors depending on a regular income from bonds. Many governments and companies have refunded bonds at lower interest rates since the early 1930's, taking advantage of their power to redeem bonds before they fall due, with great savings to themselves.[7] If interest rates fall, bonds which cannot be called before they are due rise in market value; this gives the bondholder the opportunity of taking a capital profit, but he

[6] See Appendix C.

[7] The fall in interest rates was brought about largely by governments, some of which refunded bonds they were not entitled to redeem according to the terms of issue.

cannot then increase his income by investing in any other equally desirable security. But if the bonds can be redeemed by the company at will, on payment of a slight premium, and the company exercises this right when interest rates fall, the bondholder finds that his income has decreased for reasons entirely outside his or the company's control. A rise in interest rates leaves the bondholder in the position that he must take a capital loss if he wishes to sell the bonds, but that he cannot benefit from the increase in interest rates until his bonds fall due for payment. The bondholder is thus found to get the worst of it whenever interest rates change, whether up or down.

The effect of the redemption of bonds out of profits is to decrease the liabilities of the company, and to increase the shareholders' equity by restricting the payment of dividends. This may be illustrated by the journal entries that will be made in the books of account.[8]

Dr. Surplus
  Cr. Sinking Fund Reserve
Dr. Bonds
  Cr. Cash

These entries will be made annually; the dollar amount will be that specified in the trust deed, which will be the amount needed to extinguish the bonded indebtedness at the date fixed in the trust deed. At this date the amount of the Sinking Fund Reserve will be equal to the original amount of the bond issue. As the Sinking Fund Reserve has served its purpose of preventing the payment of dividends to this amount, it is no longer needed and may be (a) transferred to General Reserve, or (b) transferred back to Surplus, or (c) capitalized by an issue of shares, proportionately, to the shareholders.

[8] These entries are simplified by ignoring the effects of interest.

(a) *Dr.* Sinking Fund Reserve
Cr. General Reserve
or (b) *Dr.* Sinking Fund Reserve
Cr. Surplus
or (c) *Dr.* Sinking Fund Reserve
Cr. Share Capital

SANCTIONS

No one is likely to plan a long-term investment in the bonds of a company, or to subscribe to a new bond issue, unless he thinks the company is likely to operate profitably; if, however, the bonds are not to be redeemed for, say, twenty years, this judgment may prove to have been faulty, and the underlying security becomes most important.

If the security is only a mortgage of specific assets (these assets must be enumerated and described in the trust deed; and the description may cover "after-acquired" assets) then default by the company in carrying out any of its obligations under the deed may be followed by the seizure and sale of the mortgaged assets by the trustee. In the meantime, the company has no power to dispose of these assets. The security is very often increased through the granting by the trust deed of a floating charge over all the other assets of the company, not included in the specific assets mortgaged; in these circumstances, the company can dispose of such assets in the ordinary course of business, usually replacing them by other assets. A floating charge gives the trustee the power to seize the business on default by the company, and the trust deed usually provides for the appointment of a receiver and a manager to operate the business. The trust deed allows a certain number of days during which the company may remedy its default before sanctions are applied; it may also provide that a certain proportion of

the bondholders may bind the whole in modifying the terms of the deed or in giving instructions to the trustee. The deed may further provide for the appointment, by a majority, of a committee to represent the bondholders and to act on their behalf. Arrangements may be made for the reorganization of the company by agreement between the bondholders, other creditors, and shareholders, the bondholders consenting to a reduction or postponement of their claims in the expectation that improved conditions or better management will enable the company to meet its new obligations, and leave the bondholders better off than if they had rigidly applied the sanctions permitted.[9]

Types of Bonds

The names given to bonds provide only a general description of them, and the actual conditions attached to them are contained in the trust deed. The first three of the types described are used more frequently by governments than by companies.

(*a*) *Funding Bonds.* Bonds which are issued for the purpose of replacing short-term or call loans by long-term loans may be called funding bonds; the body issuing the bonds benefits by acquiring certainty for a long period as to its command over funds, and as to its obligations.

(*b*) *Refunding Bonds.* These are bonds issued to take the place of other bonds falling due for redemption or which the issuer has the power to redeem. They are offered to the holders of the old bonds as an exchange, the balance being sold elsewhere and the cash received used for payments to those bondholders who insist on redemption in cash. The interest rate on the new issue will not necessarily be the same as on the old bonds, but will reflect current market conditions.

[9] See Chapter XI.

(*c*) *Consolidated Bonds.* These are bonds issued for the purpose of consolidating into one a number of separate bond issues, the opportunity often being taken to increase the amount of the total issue, and to adjust the interest rate. The holders of the new bonds benefit by having a broader security and a freer market.

(*d*) *Registered and Bearer Bonds.* Bonds may be registered as to interest: that is to say, the interest is paid by cheque to the person whose name appears in the bond register as the holder of the bonds on the date fixed; and they may also be registered as to principal: that is to say, the title to the bonds is transferred by delivery and registration of the transfer with the company. The title to bearer bonds is transferred by delivery, the company having no record of the identity of the bondholders. The interest on bearer bonds, and on bonds registered as to principal only, is paid by the cashing at a bank of coupons detached from the bonds.

(*e*) *Sinking Fund Bonds.* The fact that the trust deed provides for annual payments by the company to the trustee for the redemption of bonds leads to the use of this name.[10]

(*f*) *Collateral Trust Bonds.* These are bonds secured by the mortgage of bonds or shares of subsidiary or other companies. Occasionally a company may mortgage part of a large issue of its own bonds as security.[11] The company issues to the trustee for the bondholders of the public issue an appropriate number of bonds of the large issue, and may ultimately have several bond issues secured in this way. The advantage appears to be that the mortgage of assets is made under the trust deed for one large issue,

[10] See above: "Redemption".

[11] E.g., Canadian Pacific Railway Co. 30 Year 4½% Collateral Trust Gold Bonds, due 1960.

and that the trust deeds of the public issues can be comparatively simple; the current interest rate can be attached to each public issue as it is made.

(*g*) *Serial Bonds.* Governments, in particular, may make a large issue of bonds which, instead of being redeemed through annual sinking fund payments, are redeemed in blocks at fixed intervals, each bond being part of a series from the time of issue. Bonds with different maturity dates may have different interest rates.[12]

(*h*) *Income Bonds.* Almost all bonds bear a fixed interest rate; however, income bonds receive interest payments only if the company has earned sufficient during any particular year to meet the charge; if no interest is payable in a particular year, no liability for its payment remains. The interest rate on income bonds is naturally rather higher than on other bonds. The accounting practice of the company is obviously of great importance to holders of this type of bond.

(*i*) *Convertible Bonds.* Some bonds are issued which give the bondholder the right, within a certain period of time, to convert his bonds into shares at a rate laid down in the trust deed. With certain types of companies a provision of this sort may justify an appreciably lower interest rate on the bonds.

(*j*) *Gold and Multi-currency Bonds.* Governments and companies in immature countries, or in countries with currencies which appear likely to fluctuate, have frequently issued bonds which are payable, as to both principal and interest, in more than one currency, or in terms of gold, at the option of the bondholder. Such bonds carry with them a speculative attraction for the bondholder (or, if he is a foreigner, give him security in

[12] *Cf.* Premium on redemption according to sliding scale, see above: "Redemption".

his own currency), but may be disastrous for the issuer, faced by a liability which is quite indeterminate. If a company cannot borrow without such an arrangement it should probably not borrow at all; governments are not always in a position to exercise choice in this way. The Gold Clauses Acts 1937 and 1939 made inoperative any undertaking in a trust deed to make a payment whose amount was to be determined by reference to gold.

(*k*) *Premium Bonds.* Some foreign governments (e.g., France) have issued bonds with a sort of sweepstake attached; each year a proportion of the bonds is redeemed by drawings, and some of the bonds drawn carry with them prizes of various amounts. Some governments (e.g., Spain) have dispensed with the bond issue and run a lottery by itself as a source of funds.

(*l*) *Debentures.* The term "debenture" is not clearly defined; in England the word is used in place of "bond", while in this country a debenture is not usually secured by a mortgage of assets.

(*m*) *Open and Closed-end Bonds.* If all the bonds authorized by a trust deed are issued at one time, they are closed-end bonds; if further bonds can be issued from time to time by the company, up to a fixed limit, or proportionally to the value of after-acquired property, the bond issue is "open".

(*n*) *Perpetual Bonds.* Although not common, some issues of perpetual bonds have been made. They may be perpetual in the limited sense that the issuing corporation is under no obligation to redeem them at any time, but has the right to call them for redemption at specified times and at specified prices. The market value of these bonds is not likely to advance far beyond the price at which they can be called. Other perpetual bonds are entirely irredeemable; the issuing corporation may try

to avoid paying high interest rates indefinitely by purchasing the bonds in the market, but it has to pay the market price, which may be high if a considerable fall in interest rates has taken place between the date of issue and the date when the corporation has funds available to make the purchase. Most of the perpetual bonds in Canada are called Debenture Stock.

The Dominion made an issue of this type in 1936, which is callable from 1966; the city of Halifax and a subsidiary of British Columbia Power Corporation both have perpetual bonds which are callable. The Canadian Pacific and Grand Trunk Railways made issues which are irredeemable; much of the Grand Trunk issues was held in England, and was acquired by the Canadian National Railways during the war. The city of Montreal escaped the continuing burden of a high-interest-bearing and irredeemable issue by a general reorganization of its finances authorized by the provincial legislature.

CHAPTER V

Financial Structure

General

Conditions vary so much from one company to another and from one time to another, that only tentative statements can be made about the financial structure of companies. The public may be invited to subscribe funds for companies:[1] (a) formed to undertake entirely new ventures; (b) formed to take over an existing business which has been operated as a sole proprietorship, a partnership, a private company, or a public company; (c) to allow of expansion in operations; and (d) on the reorganization of a company which has operated unsuccessfully in the past but which, with new funds, has better future prospects. Except in times of speculative excitement few companies are formed for entirely new ventures;[2] even in mining, some preparatory work is done before the public is invited to participate. The largest number of companies have probably been formed to take over an existing business which started as a sole proprietorship or partnership, and which may have gone through a "private company" phase. A very large number of companies in Canada were reorganized in the period 1928-30, usually with much larger issues of bonds and shares; the larger issues were sometimes the result

[1] See also below: "Public Issue of Securities".

[2] During a boom in England in the last century the public was invited to subscribe two million pounds to launch a company "for a promising scheme the details of which will later be made public".

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of watering the stock and sometimes to provide for expansion.

Estimate of Funds Needed

To estimate the funds needed for an entirely new venture is obviously very difficult; a certain minimum scale of operation may be dictated by the nature of the business. Some help may be derived from a study of the published accounts of companies as nearly similar as may be found. The funds needed to purchase an existing business will be the largest amount the vendors can obtain; or, put in another way, the largest amount that the promoters or financial agents of the company think they can persuade the public to subscribe. A company which plans an expansion may be taking over another business, or may in fact have already financed the expansion, partly by the use of short-term funds from banks, and by running itself short of working capital; in either case the estimate will not be difficult. The reorganization of a company which has fallen on bad times will involve the raising of sufficient funds to pay off short-term loans and to provide adequate working capital, and possibly also to renovate the fixed assets.

Public Issue of Securities

The dominant factor in deciding what securities to offer for subscription is often the state of the capital market:[3] an offer of common shares may be snapped up during a speculative boom, or be a hopeless failure in a period of depression; an offer of bonds may arouse little interest during a boom, unless it bears an interest rate

[3] In the past the retention of control by a small group may have been an important factor, but the diffusion of shareholdings and the use of proxies has reduced its significance except in small companies.

that would normally be excessive, whereas at other times a company with a regular earning capacity may be able to issue bonds easily at current interest rates. If a company has issued redeemable bonds, and the general level of interest rates falls, it may find it advantageous to issue new bonds bearing lower interest and use the funds to redeem the high interest rate bonds. In the same way, some companies having issued redeemable preference shares with high dividend rates may offer for subscription (or exchange) preference shares with lower dividend rates, and redeem the original shares. This procedure is open to some objection because the company is not, presumably, more interested in the welfare of one class of shareholders compared with another, and this course of action obviously benefits the common shareholders at the expense of the preference shareholders. Such action is taken most frequently by companies which have not earned sufficient to pay dividends on common shares, and which expect to be able to do so as a result of improved conditions, and the savings on preference dividends.

Bonds Versus Shares

If a company can borrow, by means of a bond issue, at a rate of interest less than its average profit on the total of funds employed, then the shareholders will benefit more and more as the proportion of bonds to shares increases. (This is known as trading on the equity.) A company which issues bonds has to find cash to pay interest, and probably also to make sinking fund payments, each year. Unless the business is stable, and not subject to considerable fluctuations of income even in times of depression, the burden of these fixed charges may prove to be too great, and the company may be forced, through default, into receivership.

If a company is formed to supply goods or services which enjoy an inelastic demand, then it can safely raise a proportion of its funds through a bond issue; the income, for instance, of some manufacturers and retailers of consumers' goods in general demand, and of some public utilities with long-term monopoly franchises,[4] may be so steady as to ensure a minimum balance available to service a bond issue. Even companies ideally placed to meet annual fixed charges will be ill-advised to seek a large proportion of their funds through a bond issue, for this would make the risk to the shareholders great compared with the benefits they might receive through excessive trading on the equity. A mere comparison of the amount of the bond issue with the amount of the share capital leads to no valid conclusions; a careful analysis of operations over a period of years is needed, and that is one of the reasons why bond issues are recommended only for companies operating businesses with an established record of earnings over a period covering at least a "trade cycle". In the past, companies have too often planned a watered capital structure on the basis of a few boom years, and have quickly been faced with difficulties in meeting their fixed charges.

A company, or government, may have the "real" burden of its fixed charges reduced enormously by the inflation of the currency in which its bonds are issued, or by a general rise in the price level.[5] (The converse is also true, but less frequent.) The result to the bondholders may be a disastrous reduction in their "real" income and capital, and for this reason the interest rate on bonds

[4] The history of the Winnipeg Electric Co. shows that this is not true of all public utilities.

[5] This happened in many countries after the first Great War; in Germany bond issues were made completely valueless to the bondholders as a result of inflation.

may be very high in periods of uncertainty, and a new issue may be very difficult to sell.

Changes in Structure

The changes in structure that may result from financial weakness will be discussed in Chapter XI. The first important change in financial structure that should be mentioned under this heading is the redemption of bonds before maturity; this can be effected only if provided for in the trust deed. The Companies Act provides that changes may be made in the capital of a company. The procedure is the passing of a by-law, with the required majority, at a special meeting of each class of shareholders affected by the proposed change; and the confirmation of the change by supplementary letters patent. The redemption of preference shares has already been dealt with in Chapter III (under Types of Shares); four other changes that may be made in the capital of a company require mention.

1. *Reduction of Capital.* If a company has operated at a loss and its capital is no longer represented by available assets, it may reduce the par value of its shares and simultaneously write off its accumulated deficit. Contrariwise, if it has funds in excess of its needs, it may reduce the par value by the payment of cash to the shareholders. These changes can also take the form of a proportionate reduction in the number of shares held by each shareholder, the par value remaining unaltered. Similar changes can be made with shares of no-par value. When the company proposes to reduce its capital by payments to shareholders, the creditors are protected by section 51 of the act.

2. *Share Split.* The shares of any class may be split so that each share of nominal value is changed into a number of shares of a correspondingly smaller nominal value; or shares of no-par value may be changed into a larger number of shares. The usual reason for splitting

shares in this way is to reduce the market value, which may have become so high as to narrow the market; it may also be to reduce the apparent dividend rate, which may threaten to become embarrassingly high.[6]

3. *Change in Type.* One of the commonest changes in capital in the recent past has been the change of shares with a nominal value into shares of no-par value.

4. *Change in Conditions.* Although a company is not in financial difficulties, it may have passed through a period when the payment of dividends on preference shares has seemed inadvisable to the management, and if these dividends are cumulative, a considerable amount of arrears may have accumulated. Better times arrive, but the common shares cannot receive dividends until all the arrears of preference dividends are paid; the holders of common shares have naturally been aware of this fact. However, a tradition has been built up that, in these circumstances, equity suggests that some arrangement should be made so that all shareholders may benefit from the new prosperity, and the management puts forward a scheme by which the arrears are cancelled, often by the issue of common shares to the preference shareholders in compensation. A change in the rate of preference dividends may be made at the same time.

Canadian Breweries Ltd. eliminated arrears in 1934 by increasing the rate of preference dividends; in 1942 further arrears had developed; the rate was increased again and the redemption price was also increased. In 1945, each preference share was converted into three common shares. Massey-Harris Co., Ltd. reorganized in 1941, when each 5% Preference Share of $100 was exchanged for four new 6¼% Preference Shares of $20 each and three new Common Shares of no-par value; arrears of $50 per share were cancelled. The common shareholders received one new share for two old shares.

[6] The Canadian Pacific Railway split its shares, four for one, in 1930 when the market price was about $200.

What advantage the preference shareholders are expected to derive from changes of this type is, of course, stated, but why they are convinced of the advantage is sometimes obscure. The opposition of some of the preference shareholders in Simpsons Ltd. is supposed to have caused the management to withdraw such a scheme. In 1945, they redeemed the 6½% Preference Shares, paid off the arrears in cash, and issued new 4½% Preference Shares; at the same time, they split the Common Shares three for one.

A company needing new capital may find that it can be obtained only by offering shares with more attractive conditions than those attached to existing shares, and a proposal to create such shares will be put forward. All the changes in conditions mentioned above must be presented to meetings of each class of shareholder concerned. If the changes are passed by the required majority, they must be submitted to a judge for approval, and dissident shareholders are entitled to receive notice of the hearing, and to attend to present their case. If approval is given, the scheme is binding on all shareholders.

Examples of Financial Structure

Some companies have had simple structures since their promotion; others have gone through several metamorphoses, and have strange conditions attached to their shares and bonds as the result of reorganizations. The fact that a company now has no bond issue does not mean that it may not have redeemed an earlier bond issue; nor does the absence of preference shares mean that such shares may not have been redeemed in the past. The examples given below show a wide variety of shares and bonds; a study of these and other examples reveals no regular pattern, even within an industry. A thorough examination of the structure and financial history of companies supplies a foundation for the formulation of

only the most general principles, and shows no direct relation between the assets and the sources from which the companies have derived their funds. The amounts shown below are of shares and bonds outstanding, in round figures.[7]

UNITED FUEL INVESTMENTS LTD.

Share Capital $6,500,000

90,000 Class A 6% Cumulative Preferred Shares of $50 each, redeemable at $60; elect two directors if dividends in arrears for two years.

78,412 Class B Preferred Shares of $25 each, purchasable in the market for cancellation by the company up to $30 each. Receive the same dividends as the common shares, but have a preference as to capital on winding up. No voting rights.

90,000 Common Shares of No-par Value, held by trustees for two controlling companies. Full voting rights.

Bonds $6,400,000

$450,000 6½% General Mortgage Bonds, held by associated company.

$2,000,000 5% First Mortgage Sinking Fund Bonds, giving a first mortgage on property and a floating charge on other assets.

$550,000 6% General Mortgage Sinking Fund Bonds, similar to above but giving a second mortgage.

Three bond issues of wholly owned subsidiary companies, totalling $3,250,000.

The share capital was reorganized in 1938, when arrears of dividends on old preferred shares were cancelled, and each holder of old preferred shares received both Class A and Class B shares in equal numbers; an arrangement which, without knowledge of any special reasons, seems needlessly complicated.

THE CONSUMERS' GAS CO. OF TORONTO

Share Capital $14,400,000

145,552 Common Shares of $100 each.

Additional shares have been issued from time to time, at a premium, to finance expansion.

MASSEY-HARRIS CO. LTD.

Share Capital $14,400,000

483,596 6¼% Preferred Shares of $20 each, redeemable at $30. Cumulative (subject to special conditions until 1940), and convertible into two common shares; non-voting except for right to elect one quarter of the directors.

732,508 Common Shares of No-par Value.

[7] Some of the information given here is derived from the Financial Post Survey of Corporate Securities.

Bonds $8,900,000

4-4¼% First Mortgage Bonds (two series) $7,600,000, giving a first mortgage on all Canadian property and shares of subsidiaries, and a floating charge on other assets. A sinking fund is to be started in 1946.

$1,300,000 Bonds of U.S.A. subsidiary are guaranteed.

A reorganization in 1941 resulted in the cancellation of arrears of dividends on old preferred shares, and a writing down of the capital.

COCKSHUTT PLOW CO. LTD.

Share Capital $6,400,000

300,678 Common Shares of No-par Value.

In 1928 the existing preferred shares were converted into common, and arrears of dividends were cancelled. In 1935 the book value of the capital was reduced by $4,500,000 and a similar amount was written off goodwill; this could be done only with no-par shares.

BRANDRAM-HENDERSON LTD.

Share Capital $315,000

50,000 Common Shares of No-par Value.

Bonds $825,000

6% First Mortgage Income and Fixed Interest Bonds. Interest payable when available from income, non-cumulative to 1941, cumulative to 1947; interest a fixed charge from 1947. A first charge on property and securities, and a floating charge on other assets. Redeemable at $105.

Preferred shares and accrued bond interest were converted into common shares in a complete reorganization in 1936; the bondholders are protected by complex restrictions on the payment of dividends.

INTERNATIONAL PAINTS (CANADA) LTD.

Share Capital $840,000

42,000 5% Cumulative Preferred Shares of $20 each; the dividend rate increases to 6% when arrears of dividends of old preferred shares are paid. Participate equally with common shares in further dividends, and have preference in liquidation of $25 a share plus arrears of dividends. Voting rights only when dividends in arrears for two successive years.

20,860 Common Class A Shares of No-par Value; non-voting.

7,140 Common Class B Shares of No-par Value; full voting rights.

The capital was reorganized in 1936. A small number of sterling bonds were issued to finance the purchase of a subsidiary, and these have been paid.

CANADA IRON FOUNDRIES LTD.

Share Capital $5,500,000

38,778 6% Preferred Shares of $10 each; non-cumulative (which is unusual) and redeemable at $10.

15,989 Common Shares of $10 each.

A sinking fund bond issue, which was due in full in 1939 was paid off in 1934.

DOMINION STEEL AND COAL CORPORATION LTD.

Share Capital $26,000,000

1,039,083 Common Shares of $25 each.

Bonds $11,200,000

$4,400,000 6¼% Cumulative Participating Income Bonds. Interest payable, if earned, in sterling at a fixed rate of exchange, or in Canadian dollars, at the option of the company. Participate to the extent of 10% of any amount over $1.50 a share paid in common dividends; and convertible into four common shares for each $100 bond.

Bonds of wholly owned subsidiary companies amount to $6,800,000.

The company was in the hands of a receiver for the bondholders in 1930, when a reorganization was effected; a further reorganization took place in 1935. The provisions attached to the present bond issue must be the most curious mixture ever known.

H. SIMON & SONS LTD.

Share Capital $350,000

2,649 7% Cumulative Preferred Shares of $100 each, redeemable at $110, and with a sinking fund for this purpose. Convertible into two common shares each; non-voting unless dividends in arrears for one and a half years.

30,050 Common Shares of No-par Value, with restrictions on the payment of dividends to give additional protection to the preferred shares.

During a period when dividends were not being paid on the preferred shares, some of these shares were apparently purchased in the market at less than par, and cancelled.

CHAPTER VI

The Capital Market

Definition

The capital market is concerned with the investment of funds in long-term securities by the issue and distribution of bonds and shares, and by subsequent trade in them. The market is divided into three main sections: first, the government bodies which issue bonds and the corporations which issue bonds and shares; second, various institutions which have developed to facilitate the issue, distribution and trade in these securities; and third, the general public and certain financial institutions which have funds for investment.

Corporations and, to a certain extent, governments have other outside sources of funds: commercial credit (based largely on trade customs) and short-term loans. Short-term loans are the concern of the money market and are provided chiefly by the commercial banks, with the support of the central bank. The money market is distinct from the capital market, but influences it in various ways: first, the discount policy of the central bank and the interest rate of the commercial banks may, in the long run, affect the yield on bonds; secondly, the open market operations of the central bank affect the capital market directly because they take place in that market; and thirdly, the bank rate affects the policy of those who borrow from commercial banks in order to invest in bonds and shares.[1]

[1] See A. F. W. Plumptre: *Central Banking in the British Dominions*, Introduction. He treats the capital and money markets as one. The foreign exchange rate is influenced by central bank policy and has sometimes had an important effect in attracting or repelling funds in the capital market: see J. F. Parkinson (ed.):

Sources of Funds

The issue of new securities has become less important as a source of funds for corporations, and profits retained are now the largest single source.[2] This has had the effect of reducing the importance of the capital market, and of providing for the large-scale investment of funds as a result of managerial decision, without any testing by the capital market. The management may, however, be concerned largely with the squeezing of water out of the capital,[3] and the watering of stock in the investment boom of the late twenties is undoubtedly responsible in part for the large-scale retention of profits in the thirties.

Financial institutions have also increased in importance as a source of funds for corporation and government security issues;[4] some of them have funds available for investment as a result of profitable operation, but their funds are mainly held by them on account of individual members of the general public. These institutions will be considered in more detail almost immediately. Certain charitable, educational and religious institutions (e.g., the Rockefeller Trust, the Ecclesiastical Commissioners in England, and Harvard University) have large funds invested. Finally, the savings of individuals and of corporations, invested directly by them, are an important source of funds, but that they are not as all-important as has sometimes been supposed has been shown above.

Financial Institutions

The chief financial institutions are listed below, with short notes showing their chief sources of investment funds

Canadian Investment and Foreign Exchange, Ch. IX; see also N. J. Silberling: *The Dynamics of Business,* Ch. 16.

[2] See Appendix D; also E. E. Lincoln: *Applied Business Finance,* pp. 182-3 and 753; C. Clark: *National Income and Outlay* (London, 1937), p. 185; and N. J. Silberling: *The Dynamics of Business,* p. 443.

[3] See Chapter III, under "Watered Stock".

[4] Temporary National Economic Committee: Final Report of Executive Secretary, p. 216.

and the part they play in the capital market. Some of their other functions are also indicated. Those financial institutions which play an important part in the capital market may be expected, as a result of their close acquaintance with and study of the market, to exercise better judgment than the general public, and thus to provide a steadying influence on prices.[5] They often take advantage of small price changes, and they have large funds for investment; and as they trade through dealers they are a very important part of the capital market, and may receive special treatment by dealers.

(*a*) *Banks.* The central bank has the responsibility of exercising control over the money, credit, and foreign exchange rate of the country. Its funds are provided by its capital, by the deposits of the commercial banks, and by its power to create credit; and these funds are used in part in open market operations: the buying and selling of government bonds. The commercial banks derive most of their funds from the deposits of customers and from their power to create credit; their prime function is the provision of short-term loans, but they have increasingly become holders of bonds, partly because of the decrease in demands for loans caused by the retention of profits by corporations.

(*b*) *Insurance Companies.* The chief source of funds in the hands of insurance companies is their premium reserves. Life insurance companies have grown rapidly, and their premiums far exceed their claims. Even if they should eventually reach an equilibrium, they will remain an important factor because they will still be large holders of securities, and will constantly be changing their holdings. Insurance companies are restricted by law in their investment policies. They are large holders of bonds; some are also large holders of shares; while others place more emphasis on mortgages, and are also making loans under the

[5] See, however, Guthmann and Dougall: *Corporate Financial Policy*, p. 349.

Dominion housing scheme. Loans on policies use a considerable portion of their funds.

(*c*) *Trust Companies.* The department-store type of financial institution[6] derives funds from many sources and uses them in many ways. Trust companies accept deposits from customers, act as executors, and administer estates and voluntary trusts. The funds that come into their care through these activities are available for investment in mortgages and long-term securities, subject to legal restrictions. In addition, they issue guaranteed trust certificates, investing the proceeds of these issues in stated securities. They act as trustees for bondholders, and as registrars and transfer agents for the shares of companies; also as liquidators of companies and as receivers in bankruptcy.

(*d*) *Loan and Mortgage Companies.* Some of these companies obtain funds by the issue of bonds as well as shares; they also accept deposits. Their business is largely that of lending on mortgages but they also invest in long-term securities; they are subject to government regulation in their investment policy.

(*e*) *Finance and Discount Companies.* The main business of these companies is the financing of instalment purchases, by discounting notes given by dealers to manufacturers and notes given to dealers by purchasers. They may also hold long-term investments.

(*f*) *Investment or Investment Trust Companies.* These companies are different from the other institutions discussed in that they are formed for the sole purpose of the investment of their capital in bonds and shares. They provide an opportunity for the comparatively small investor to diversify his interests without buying small quantities of many issues. They depend for their success on the judgment and policy of the management, which has not always been free from criticism. Some of these companies, at times of rising share

[6] H. G. Moulton: *Financial Organization and the Economic System*, p. 337.

prices, have treated gains from the sale of securities at a price higher than cost as profits available for distribution in dividends, and have subsequently, when prices have fallen, been left with diminished capital and low earning power; the best management has always reinvested gains of this type. The fallacy of distributing such gains is evident from the fact that, after a number of changes in holdings, the company may have precisely the same portfolio of investments at the end of the year as at the beginning of the year; if no changes had taken place, no gains would have been made.

Most of the Canadian investment companies hold chiefly domestic issues (in England, many such companies have been formed for foreign investment in particular areas). The company by-laws may restrict the freedom of the management by limiting the proportion of available funds invested in any one security, thus maintaining the diversification that is their chief attraction; or by limiting the proportion of the securities of another company that may be held, thus avoiding management responsibilities in that company.

Distribution of New Funds

The funds which become available for long-term investment from the sources discussed above may be used either to subscribe to new issues of bonds or shares, or to make purchases of existing securities; if the latter, then those who sell the existing securities have funds available. If no new issues are forthcoming the prices of existing securities will rise through the competition of investors, but the new funds or those which they displace must eventually be withdrawn from the capital market and find other outlets. The methods by which new issues are made are best discussed under the two headings: bonds and shares.

Bond Issues

Issues of bonds may be made for the purpose of re-

funding existing bond issues,[7] or to obtain additional funds. Bond dealers perform most important functions in the issue of and subsequent trade in bonds; most of them are organized as limited companies. The method of issuing bonds used by the Dominion government is different from that used by others in Canada. The Dominion government receives advice on the terms of bond issues from the Bank of Canada, and the bonds are issued to the public through that bank. Bond dealers, chartered banks and other financial institutions aid in the distribution of the bonds to the public by the advice they give to their clients, and they receive a commission on all applications submitted through them. In the past, the Dominion has made bond issues through dealers in London and New York, but now has a fixed policy of making issues only in Canada, although foreign interests may subscribe to them.[8]

While some provincial bond issues are made by public tender, the provinces usually turn to a bond dealer for advice on the terms of issue, and arrange to sell the whole of an issue outright to that dealer and any other dealers who may be associated with him as a syndicate, for the purpose of distributing the issue to the public. The dealers are compensated by the difference between the price which they pay to the province and the price at which they sell to the public. They take a certain amount of risk, because they may have difficulty in distributing the issue, but they are guided in the terms of issue by the current market price of comparable bonds, and the risk in Canada is not great. The provinces have also disposed of bonds to dealers in London and New York, but much less frequently in recent years.

Municipalities and School Boards usually offer bonds

[7] See Ch. IV, under "Types of Bonds".

[8] The Dominion government also issues Treasury Bills by public tender; these are short-term bills, bearing low interest rates, held mostly by the Bank of Canada and the chartered banks.

for tender by bond dealers. They fix a rate of interest in keeping with current yields of comparable bonds, and the dealers submit tenders of so much per $100 bond for the whole issue. The dealer whose tender is accepted hopes to dispose of the issue to the public at a higher price than he paid for it. Dealers will be at some pains to investigate the financial position of the body making the issue, and to estimate its ability to meet annual payments for interest and redemption. Government, municipal, and school bonds are usually serial bonds or bonds which are repayable by annual instalments. The Dominion has one issue of perpetual bonds.

Corporations seek the advice of a bond dealer on the terms of issue of bonds, and, when agreement is reached, sell the issue outright to him. If the issue is a large one, a syndicate of dealers may be formed in order to distribute it more rapidly to the public. Dealers do not wish to hold large quantities of any bonds, particularly of some corporation bonds, for long periods, because of the risk of changing conditions reducing their value.

The Bond Market

Although the general public holds large quantities of Dominion government bonds, largely as a result of Victory Loan Campaigns, by far the largest holders of bonds are the financial institutions; other institutions with endowments are also large holders. No organized market exists for bonds, although the dealers are joined together in an association; the association publishes lists of prices of the leading issues daily. Some dealers act only as brokers, receiving orders from clients to buy or sell at a fixed commission. Most of the dealers, and particularly the large ones, act as bond merchants, buying from and selling to their clients. The dealers may offer to large-scale buyers (usually financial institutions) special prices, lower than

those offered to the general public. No information as to the volume of transactions is available but many transactions do take place, and in so far as the buying and selling is ultimately between institutions, the changes those institutions make cannot *all* be for the best. The bond dealers employ salesmen who keep in close contact with institutions and other clients by personal visits and by telephone. As the competition between dealers is keen, the market for established issues may be a good one from the investor's point of view, in spite of the absence of an organized market. Bond dealers depend on the chartered banks for loans on the security of the bonds they hold, when they purchase an issue and do not dispose of it fully by the date on which payment has to be made to the corporation, and also to enable them to maintain an inventory of bonds to offer to their clients.

Shares Issues

Shares may be issued on the promotion of a new company, or by an existing company in need of additional funds. The usual method of issue by a new company[9] in Canada is similar to that followed in the sale of a company bond issue: the whole issue is subscribed by a firm of stockbrokers,[10] who distribute the shares to the public. If the shares have a nominal value, the amount of the commission paid to the broker (the difference between the nominal value and the price of issue) must be disclosed in the prospectus,[11] if the shares are no-par shares, no "commission" can be determined, and the Companies Act appears to make no provision for the disclosure of the price at which the issue is made to the broker. The broker, in subscribing to

[9] For mining companies, see below.

[10] Some stockbrokers are also bond dealers, or closely associated with a bond dealer; this facilitates the simultaneous issue of bonds and shares by a company. Bond dealers who have no direct affiliation with stockbrokers may handle an issue of shares.

[11] See below, under "Regulation of Issues".

an issue of shares, is called an "underwriter"; he relies on the chartered banks to provide, against the security of the shares, the funds which he must hand over to the corporation on a fixed date, and which have not been supplied by the sale of shares to the public. Precautions are taken by underwriters to prevent the market price of the shares they hold from falling below the price at which they are trying to dispose of them to the public; these precautions may take the form of an offer to buy at that price any shares which are offered for sale. The danger, and the precaution, are generally to be found when the shares are quoted on the stock exchange, and when the prices at which transactions take place are therefore given publicity.

The usual method of issue of new shares by an existing company in Canada is the same as that described above. This method may, however, act to the detriment of the old shareholders; this is particularly likely to happen when the shares have no par value. Suppose, for instance, that a shareholder paid $80 a share for his holdings and that the current market price is $82. If the directors proceed to make a new issue of the same class of shares at $75 a share, that shareholder's interest in the company is diluted. Some companies, less frequently now than in the past, avoid this possible injustice by offering new shares to the old shareholders in proportion to their holdings, but it appears doubtful whether shareholders can claim this pre-emptive right.[12] If the right is granted, a market may be created in "rights", and shareholders who do not wish to participate in the new issue may dispose of their rights to others. The offering of new shares to existing shareholders, at a price well below the market price, would make certain of the success of the issue and would avoid the services of and payment to underwriters, without detriment to the com-

[12] Cf. Masten and Fraser: *Company Law of Canada*, pp. 190-1. See also Berle and Means: *The Modern Corporation and Private Property*, pp. 144 ff.

pany, but this is seldom done—possibly for that reason.

Bank Loans and New Issues

Now that the method by which new issues are made has been described, reference may again be made to the sources of funds made available by financial institutions, corporations and individuals. Financial institutions derive their profits largely from investments of one sort or another, and if they are managed efficiently, they do not have funds lying idle. Corporations and individuals are more likely to accumulate bank balances, and to make investments only at intervals. However, when a large issue of bonds or shares is made it is not taken up immediately out of bank balances, and to whatever extent existing investments are sold to provide cash, this reduces the cash savings of the purchasers of those investments. Bond dealers and stockbrokers who purchase the whole of an issue, and do not dispose of it fully to the public by the date on which payment to the corporation is due, borrow from the banks against the security of the remaining bonds or shares[13] and the process of absorption by savings is gradual; savings made after the date of issue are used to some extent to purchase the issue. This is illustrated very clearly when the government makes a very large bond issue, as in time of war. Financial institutions borrow from the banks, and they pay off their indebtedness out of funds which become available later. The same is true of corporations and individuals, special arrangements being made for them to buy on what is really an instalment plan, financed by the banks.

Expert Advice on Issues

Criticism has been expressed, particularly in retrospect after the collapse of a speculative boom, of the fact that bond and share dealers offer expert advice to clients in

[13] See an interesting discussion in F. Machlup. *The Stock Market, Credit and Capital Formation*, p. 107.

respect of securities which they themselves hold, and are particularly anxious to sell; and that the strength of their advice may vary directly with their anxiety to sell. In the late 1920's, some bond dealers, particularly in the United States, encouraged foreign governments to issue bonds, without any proper investigation of their long-term prospects, which were then distributed by the dealers with disregard for the interests of their clients, and with enormous profits to themselves.[14] Some of the dealers went so far as to promote investment trust companies for the purpose of relieving them of excess stocks of bonds.

During the same period and during many similar periods in the past, dealers encouraged corporations to make ill-advised bond and share issues which they then offered to the public in glowing terms, seldom justified by subsequent events. Dealers who had built up reputations for sound advice during comparatively safe periods, used and lost these reputations in their efforts to distribute the securities to the public; but the public memory is short. Some underwriters arrange for a representative to sit on the board of directors of companies whose issues they sponsor, but this is no guarantee of success. Not all issues, of course, are disastrous, even when made in times of speculative excitement, and some dealers have had a good record over very long periods.

To give advice on investments is easy during calm periods of gradual expansion, but, judging by the available evidence, the advice given at most times is based on inadequate information and frequently on faulty reasoning. Much of the advice is that which is based on inside information, but that usually reaches clients after a time lag, during which the cream has been skimmed off; the opinion has been expressed and supported by evidence[15] that, on the

[14] F. Pecora: *Wall St. Under Oath*, Ch. 5.
[15] F. I. Shaffner: *The Problem of Investment*, Ch. XXI.

average, a random choice of investments may be as good as one based on available "expert" advice.

Attention has already been drawn to the fact that dealers may have a personal interest in advising the purchase of bonds or shares, the issue of which they have underwritten. Dealers and brokers also have a very strong incentive to recommend to their clients change in their holdings of investments as often as possible; the advice is given free, for the income of the dealer or broker comes mainly from transactions made on behalf of clients.

Regulation of Issues

The protection of the public against the promoters of companies is difficult; the principle of *caveat emptor* has long been recognized as insufficient, for the issue of securities by a company (and particularly by a newly promoted company) is very different from the sale of goods to which the principle was originally applied. On the other hand, legislatures have been at pains to avoid any such control of issues as would give the impression to the public that the government had put a stamp of approval on them. The control of the issues of bonds and shares by companies obtaining their charters under the Dominion Companies Act consists of the filing of a prospectus with the Secretary of State, and the requirement that a copy of the prospectus shall be delivered to or sent to the applicant for bonds or shares so that he may receive it twenty-four hours before his application is accepted.[16] The act provides that the prospectus shall contain certain information designed to give the applicant a proper basis on which to judge the issue; if the information is misleading he may have the contract rescinded.

In view of the fact that many issues of bonds and shares

[16] This is not required if the issue is to be made exclusively to existing shareholders.

are sold to underwriters, and not therefore, issued by the company to the public, the act provides that the requirements as to the prospectus shall apply equally to the distribution of securities by underwriters; doubt has been expressed[17] whether the Dominion has any jurisdiction over any trade in securities after they have once been issued by the company, and no case has yet been decided on this point. The provinces have, however, made regulations which apply to issues of any corporate securities within the province, or by a company which operates within the province: the Companies Information Acts of Ontario and Quebec, for instance, require the filing of a prospectus in these circumstances. Further, the provinces have made regulations governing the conduct of underwriters and their agents: for instance, the Securities Acts of Ontario and Quebec and the regulations under those acts. The regulations of the Securities and Exchange Commission in the United States[18] are more elaborate than the Canadian regulations, and are likely to discourage the issue of securities in the United States market by Canadian companies.

Mining Companies

An established mine with very large ore reserves is not essentially different from other business enterprises[19] but the early days of a new prospect are highly speculative, and the method of financing many mines is entirely different from methods used in other businesses. A great deal of the prospecting for new ore bodies is carried out by existing mining companies which have cash available from undistributed profits; these companies are also willing to purchase promising claims staked by individual prospectors. If an existing company decides to develop a new property, it may do so by expanding its own organization, or it may float a

[17] Masten and Fraser: *Company Law of Canada*, p. 468.
[18] See N. J. Silberling: *The Dynamics of Business*, p. 420 ff.
[19] Except that gold mines sell a product at a fixed price.

new company for the purpose; if it floats a new company, it may retain full ownership or issue some of the shares to the general public. The floatation of a subsidiary will not usually take place until a considerable amount of development and testing has been carried out by the parent company.

Another method is used on a large scale when the mining market is buoyant. The prospector disposes of his claim to a small group of promoters, who examine the property and obtain expert reports from geologists. If the reports are favourable, a syndicate[20] may be formed, with participation by the public, to provide funds for development and further testing; if the results are favourable, a company is promoted, the syndicate receiving shares in payment for their rights.

When a new company is formed, either to take over from a syndicate or to purchase claims from prospectors, the distribution of shares to the public is undertaken by stockbrokers.[21] They purchase a certain percentage of the shares from the company, and receive an option to purchase further blocks of shares at certain prices; their interest is therefore to encourage a rise in the market price of the shares and to prevent any fall in price. Arrangements are usually made for the shares to be listed by the stock exchange as soon as possible,[22] and distribution of the shares by the brokers to the public then takes place through the exchange. The success of this method of issuing shares depends on the market remaining favourable, and if the price can be pushed up, enormous profits may be achieved by those holding options; the temptation to manipulate market prices is obvious.

[20] See The Prospecting Syndicate Agreements Act (Ontario), 1945.

[21] Gold deposits in Canada are not as easy to prove as in South Africa, and this may account for the difference in methods of financing their development. See A. F. W. Plumptre: *Central Banking in the British Dominions*, p. 139.

[22] The Toronto Stock Exchange is by far the largest Canadian market for mining shares, and by far the largest number of mining companies have Ontario charters, even if their properties are in other provinces.

The funds needed in the early days of a mining company are usually small; they are obtained almost exclusively from the issue of shares, although a few bond issues have been made, particularly by companies promoted by existing companies. The companies often issue only such shares as are necessary for the immediate work on hand, so that, if success attends them and further development is required, additional shares may be issued at higher prices. However, the conditions may be such that large-scale development is planned almost from the beginning, and enormous funds are required before production begins.[23]

To protect the public to some extent from over-optimistic reports or fraudulent promotions, arrangements are often made, and may be required under the Ontario Securities Act, for shares issued for a consideration other than cash to be held in escrow: that is to say, the holders may not sell them until a sufficient number of shares have been issued for cash to provide the funds necessary for the immediate purposes of the company. Compared with the number of mining companies that have been formed, few are producing companies, and fewer still have ever paid dividends; however, even those companies which are dead or dormant may have made large capital profits for their promoters. The United States has invested heavily in Canadian gold-mining companies, and in 1944-45 complaints were heard of the methods used by promoters to draw funds from that country. The administration of the Securities Act of 1945 seems likely to remove causes for legitimate complaint.[24]

[23] J. F. Parkinson (ed.): *Canadian Investment and Foreign Exchange*, p. 231.

[24] See F. V. Regan: "Securities Regulations in Ontario", *Commerce Journal* (University of Toronto), April, 1946.

CHAPTER VII

The Stock Market

Need for a Market

Large-scale enterprise, limited liability and the stock market are inextricably tied together; the funds needed for the first could not be mobilized without the second and third. The chief function of the stock market is to provide funds for long-term investment from those who wish to invest for a shorter term, or who wish to be able to dispose of their investment without undue difficulty at short notice: that is to say, the investor is interested in liquidity. This is important even for bondholders, for the bonds fall due for payment at some fixed date; it is obviously more important for shareholders, for a company has no fixed term of life and may be, for any generation of shareholders, as good as perpetual. Transferability of shares and limited liability of shareholders are the characteristic attributes of the business corporation, or, more accurately, of the limited company.

A market exists whenever transfers of property take place, but an active market is necessary, generally speaking, to provide real liquidity, and to make speculation possible. In the early days of the chartered companies, transfers of shares were infrequent, but as the number of companies increased, and the number of shareholders in each company increased as a result of larger capital, the funds available for investment also increased,[1] and trading in shares became frequent. This brought into existence specialists who

[1] Partly the savings resulting, directly or indirectly, from the operations of corporations.

arranged for the purchase or sale of shares: the stockbrokers. In 1773 the London Stock Exchange was organized by the stockbrokers, in much the same as its present form, for the purpose of facilitating and regulating the trade in shares.

Organization of Stock Exchanges

A stock exchange is a private organization which, primarily, provides a building in which its members can meet for the purpose of trading in shares,[2] either as brokers acting on a commission for customers, or on their own account. The exchange also conducts a clearing-house, through which accounts are settled and shares delivered between individual brokers and the exchange instead of by payments and deliveries from one broker to another. Particulars of all transactions are made known immediately to members on the floor of the exchange, and, by means of the ticker-tape, to others who are interested. At the end of the day's trading the press publishes exchange news consisting of the high and low prices at which each share has been traded, the total number of each share traded, and the closing bid and asked quotations. The exchange itself publishes a more detailed statement showing the price and time of each individual transaction during the day. The members of the exchange are subject to regulations, covering such subjects as minimum commissions to be charged, margins,[3] price manipulation, and advertisements. The exchange also decides what requirements shall be fulfilled by companies before their shares are "listed". The requirements include evidence of satisfactory public distribution of the shares.

The actual mechanism of trading may be indicated briefly. An order to buy or to sell is received by the office of a stockbroker and is immediately telephoned to his clerk

[2] Canadian exchanges deal only in shares; London and New York deal also in bonds.

[3] Discussed later.

in the exchange, who notifies the trader on the floor. Visual notice of prices bid and asked for shares is given to those who are trading, and when a transaction is made a note of the number and name of the shares is initialled by the two brokers concerned and handed to the exchange officials, who record it and pass it on to the clearing department. The brokers' clerks inform their offices and a "bought" or "sold" note is sent to the customers. If a broker wishes to act in a transaction as an agent for both the buyer and the seller, certain formalities are required to "put through" the transaction so that both customers may be assured that a better price cannot be obtained from another broker.

Transactions may take place in "board lots", a fixed number of shares, depending on the price; or they may be in "odd lots". In certain exchanges, but not commonly in Canada, some brokers specialize in collecting odd lots into board lots and in breaking down board lots into odd lots, and are compensated by prices for odd lots being less favourable to the customers than prices for board lots. Other brokers may specialize in particular issues of shares when trading on their own account, and be prepared to make a transaction whenever a certain price is reached.

Some people who make frequent transactions in shares through a broker keep a current account with him so that, when an order to sell is executed on their behalf, the broker keeps the cash balance to be put against any subsequent purchase. The balances left in the hands of a broker in this way may be quite large and may reduce the amount which he needs, day by day, to borrow from the bank. The significance of this will become clearer when buying on margin and short selling are discussed later.

Unlisted Shares

In some cities "curb" trading takes place in the street in shares which are not listed on the exchange; in other

cities, what was once a curb market has become an organized exchange, with regulations and listing requirements sufficiently different from those of the stock exchange proper to enable the curb exchange to carry on with profit to its members.[4]

A considerable number of shares are not listed by the stock exchange or by an organized curb exchange. The reason for this may be that a company has not asked for listing, or that it may have failed to achieve it (or that it may have been de-listed by action of the exchange committee). Many of the unlisted shares are in small companies,[5] in companies whose shares are closely held by comparatively few shareholders, or are shares in which few transactions take place; others are in companies not yet fully established, which may seek listing after a short time; others are in companies which do not wish to meet the publicity of their affairs required for listing, or which do not wish their shares to be listed for reasons the directors keep to themselves.

The method of dealing in unlisted shares is for the broker to try to carry out his customer's orders by telephoning to specialists in unlisted shares. The settlement is made without the advantage of the clearing facilities of the exchange and the transaction is not subject to the regulations of the exchange; the only publicity given to transactions is that provided by individual brokers to the press. This information consists only of the latest bid and asked prices known to that broker, in respect of a limited list of shares, at the end of the day's trading.

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[4] Montreal has a Curb Exchange; Toronto has only the one exchange, but within that exchange certain shares, with less stringent listing requirements, form a curb market.

[5] The listing fee and the cost of satisfying listing requirements may sometimes be a factor.

Buying on Margin

Shares may be bought, through a broker, for cash or on margin. If the customer cannot or does not wish to pay cash in full for shares he buys, he pays a proportion of the cost and the broker retains control of the shares, as security for the balance. The broker does not, however, supply the funds to finance the purchase, but borrows from the bank, depositing the shares with the bank as security. The amount paid by the customer—the margin—bears a relation to the market price of the shares; it is a margin of safety to protect the broker against a fall in the market value of the shares, which would leave him with less than full security for his loan to the customer. In the same way, the amount the broker borrows from the bank is the cost of the shares less the margin, leaving the bank with its margin of safety. The amount of margin is set by the exchange, and varies with the market price of the shares. If the market value of a share held on margin falls, the broker will immediately call for an increase in the margin deposited by the customer, and will sell the shares if the margin is not promptly adjusted. The bank has the right to sell the shares if its security is threatened by a fall in price not followed quickly by a decrease in the loan; in ordinary circumstances, however, the bank is concerned with general relations with a broker, and not with individual loans. Interest is paid by the customer to the broker on the unpaid balance of the purchase price and by the broker to the bank on the amount of the loan.

Purchases on margin are speculative transactions; the buyer[6] expects an early increase in the market price of the share, and hopes to sell at a profit before interest charges become significant, and he is usually content with a small, quick profit. The operations of the buyer on margin

[6] The buyer may, of course, be a broker operating for his own account.

naturally increase the volume of transactions on the exchange, but they are confined to the limited number of shares which appear, at any particular time, to have speculative possibilities.

As a result of the enormous losses experienced in 1929, when the speculative boom broke, many harsh things were said about trading on margin, and in order partly to give greater security, and partly to prevent large-scale speculation by those financially unable to bear the risks they were prepared to take, regulations are now more strict and margins higher than they were in those days. Margin transactions are not allowed in shares quoted at less than a certain price, nor in most mining shares. At various times attempts have been made to curb speculation in the stock exchange by increasing the bank rate, thus increasing the rate for brokers' loans from banks and to customers. This action may sometimes be effective, but an increase of even 5% per annum in the interest rate is obviously not likely to deter borrowers who expect to make capital gains of, perhaps, 10% per diem.

Short Selling

The converse of buying on margin is short selling. A speculator may think he foresees that certain shares will shortly fall in price, and, in order to profit by this he places an order with his broker to sell shares which he does not possess, in the hope that he will be able to buy an equivalent number of the same shares at a lower price within a short time. If a broker sells shares, he has to deliver them, and as the customer cannot provide them, the broker borrows them from someone for a fee, until such time as the customer closes the transaction by ordering the broker to buy the required shares. A customer who is selling short has to give the broker security against a possible rise in price, and this he does by a deposit of cash; if the price does

in fact rise, the broker will call for an increase in the deposit, and if this is not forthcoming, he will buy shares to close out the transaction. For the period during which the shares are borrowed by the broker he lends their full market price to the owner of the shares, and the customer is charged with the interest on the difference between this amount and his deposit. The broker himself may sell short on his own account; or he may be the one who lends shares to enable his customer to sell short; or he may act merely as the agent of a customer.

Short selling has the same effect as buying on margin in swelling the volume of transactions on the exchange, and is subject to the same limitations: it is confined to a limited number of shares at any particular time. In an active and speculative market one person may be buying on margin at the same time as another is selling the same shares short. Customers who buy on margin and sell short frequently maintain a current account with their broker, and each transaction is not necessarily subject to cash settlement.

In order, presumably, to prevent a series of short sales being used to cause a fall in price, the exchange prohibits short sales at a price lower than that of the last transaction recorded.

Stop-Loss Orders

Speculators who buy on margin or sell short may give their brokers orders to sell or buy respectively if the market price of the shares reaches a certain point. In this way they seek to limit the loss which they may incur on the transaction. But if a sudden break in price occurs, or if the shares are not being traded in large volume, the loss may prove to be greater than expected.

Manipulation

Any attempt to influence the market price of particular shares may be termed manipulation. Reference has already

been made, in discussing the issue of shares, to the actions taken by underwriters to prevent shares from falling below the price at which they are issued until they have distributed most of their holdings. This procedure prevents the free judgment of the market from being expressed in the price of the shares.

A second form of manipulation is to be found in the formation of secret pools or syndicates of speculators whose operations are designed to change the market prices of shares, with a view to profit. If a pool decides to increase the price of a particular share, it will start by placing buying orders on a small scale at prices slightly above the current market price; then it will gradually increase the volume of its buying at higher and higher prices. The effect of these transactions will be to create public interest in the share and the pool will then stop buying and will gradually sell what it has already acquired; if the manipulation has been carried out efficiently, the pool will rid itself of all its holdings before the market price has fallen to its old level. This type of operation is made possible with limited funds through buying on margin; but the amount of funds used has sometimes been very large and the profits have been enormous.[7] A similar reduction of prices can be effected through short selling, the reverse operation being carried through with a corresponding profit.

Prices can also be manipulated by members of a pool buying and selling amongst themselves a limited holding of shares at constantly increasing or decreasing prices, causing the general market price to follow their lead and enabling them to buy cheaply or sell at a high price further shares before they leave the market to find its proper level again. Prices have also been affected by bribing financial writers and

[7] The Radio pool in New York had the use of $12,000,000. See Twentieth Century Fund: *Stock Market Control*, p. 111; also J. T. Flynn: *Security Speculation*, Ch. VI.

investment counsel to praise or depreciate particular shares, usually in support of pool operations. Stock exchange regulations prohibit the manipulation of prices by members, but cannot prevent brokers from carrying out what appears to be legitimate business for their customers—although a pool of non-members would have difficulty in concealing their intentions from their brokers. The identity of the person who is really the principal in a stock market transaction may be concealed because of the use of false names or dummies, and the abuses of manipulation are undoubtedly present from time to time on all stock exchanges, although large-scale operations may now be more difficult than they were, and concealment of identity may be impossible if any official inquiry is instituted.

Arbitrage

When the shares of a company are listed on more than one stock exchange, the separate market prices are kept in line, and the markets welded into one, by the arbitrage operations carried out, usually by brokers on their own account. An arbitrage operation consists of a simultaneous purchase in one market and sale in another of the same number of a particular security, the difference in the two prices being sufficient to cover the costs and leave a margin of profit. This business requires direct telephone communication from the operator to at least two exchanges, and this is one reason why it is carried on by brokers, who need such communication for their ordinary business. Many shares are listed by both the Toronto and Montreal exchanges, and some shares in Canadian companies are also listed on the London, New York and other exchanges. An arbitrage operation from one country to another involves also a transaction in foreign exchange; this creates no difficulty when foreign exchange rates are steady, but in times of fluctuating rates, a contract for the purchase or sale of foreign currency

must also be made at the same time as the shares are bought and sold, otherwise the profit may evaporate quickly. The time for the delivery of shares sold depends on the regulations of the particular exchange; if the shares are not on hand when delivery is due, then they must be borrowed, at some expense. These difficulties are more easily overcome if the operator has a branch or agency holding membership in one stock exchange while he is operating in another.

Government Regulation

Stock exchanges and stockbrokers are subject, in Canada, to provincial government regulations which reinforce and fill in the gaps in the regulations of the exchange. The government regulations are designed to protect the customers of stockbrokers from abuses which have been disclosed in the past. In Ontario and Quebec[8] they consist of such things as the registration of brokers and salesmen, the prohibition of certain selling methods, and provisions for the audit of stockbrokers' accounts; they also give general powers of enquiry and regulation to the commission to which these duties are assigned.

Functions of Stock Exchange

The chief service provided by the Stock Exchange is that of facilitating the buying and selling of shares; of enabling small investors to provide the funds needed for large-scale enterprise; and of providing, but not always, that measure of liquidity needed by very many investors, so that short-term investors supply the funds needed for long terms by corporations. After the break of each stock market boom, doubts have been expressed as to the extent to which the exchange and its members have contributed to the exaggeration of ordinary fluctuations, or have provided the means by which funds have been transferred from the general public to expert speculators. The exchange has

[8] Under the Securities Acts of these provinces.

been harshly criticized, and its members, while admitting certain gross abuses, have been at pains to justify the established practices and customs. To the extent that the exchange provides facilities for stockbrokers to buy and sell for their customers on a commission basis, no criticism is possible; criticism is directed chiefly at stockbrokers trading on their own account, other large-scale speculators, and buying on margin and short selling.

The apologists for the exchange emphasize the fact that it provides a continuous market for the shares that are listed, and that speculation, by increasing the number of transactions, makes this more effective. An investor who holds a few shares in which thousands of transactions take place in a day's trading, can obviously dispose of those shares at any time at a price varying very little from that at which the last transaction took place. The same is true of a reasonable number of most of the listed shares, but some issues are not traded frequently, and many go through periods of very little activity, and no continuous market can then be said to exist. No conclusive evidence has been brought forward to show that speculation is necessary to provide as continuous a market as already exists. A continuous market provides additional security to banks lending against shares deposited with them, but as long as the margin of safety is sufficient, banks are not likely to suffer loss through the enforced sale of these shares, except in times of sudden crisis. Even in times of crisis, speculators do not help, unless a number of short sellers provide a comparatively small market for a short time by taking their profits.

The claim is made that speculators tend, by their actions, to maintain a fair market price, and to provide a stability that prevents changes in price from being too violent, thus rendering a service to the public. It is true that, if well-informed and able speculators are constantly on the look out for the opportunity of snatching small profits, a fair

and stable market price will result. By anticipating an inevitable movement up or down, the speculator will initiate the movement to a "proper" market price, and will spread the movement over a longer period; if an uninformed speculation has started, he will cut it short by acting in the opposite direction. It is also true that a great deal of speculation is not well-informed, and that particular movements are not inevitable, with the result that the actions of speculators may have an unsettling effect on prices. What has frequently happened is that a movement has been started by professional speculators, and then taken up by a host of amateurs, so that the movement is accentuated; the experts do not start operating in the opposite direction until the movement is almost spent, and violent fluctuations result.[9] This is quite apart from fluctuations deliberately induced by the manipulations described in a previous paragraph.

The publicity as to prices provided by the exchange is essential to the other functions it performs, although it may create unhealthy excitement amongst the amateur speculators. It also serves, to a certain extent, to direct capital into industry and commerce. If the shares of a company are already listed on the exchange, a new issue is likely to be facilitated if the market price is buoyant; unfortunately, doubt may remain whether the buoyance is not artificially produced. A rise in the price of shares in a whole industry, may make easy the promotion of a new company in that industry; a general rise in the market will encourage the promotion of many new companies. If the rise in the market price of shares in a particular industry, or in general, is the result of feverish speculation, then new and ephemeral

[9] H. G. Moulton: *Financial Organization and the Economic System.* "The traditional view that margin trading tends to promote market stability does not therefore appear well founded and is certainly not supported by any statistical evidence" (p. 224). "The wide fluctuations that have characterized the market in recent times have undoubtedly been amplified by speculative activities, participated in by the public as well as by professional operators" (p. 225).

companies will spring up, with profit to the promoters and loss to the general public.[10]

The vested interests in margin buying and short selling are strong; the public has a short memory and is attracted by speculative opportunities. The arguments in favour of short selling are not particularly convincing, and it is far more different from margin buying than is sometimes believed; the buying of shares on an instalment plan, or borrowing on the security of shares, may have nothing whatever to do with speculation, but the sale of shares not owned by the seller is essentially a speculative transaction, and cannot be anything else. The difficulty of distinguishing speculation from other activities in margin buying, and the ease with which prohibitions could be circumvented, will probably leave margin buying subject only to some regulation, but short selling would probably not survive another stock exchange break such as that of 1929.

Volume of Brokers' Loans

The amount that brokers borrow from the banks varies from day to day and is governed by two major factors: the amount that their customers borrow from them for margin buying and the extent to which customers leave balances in their hands, instead of requiring a cash settlement after each transaction. Speculation by brokers on their own account may also be important in amount. An increase in speculation is not necessarily accompanied by an increase in brokers' loans,[11] for speculators do not usually expect a cash settlement after each sale. If, at any particular time, a large number of shares were bought on margin and all the sales were made by customers for cash, then the amount of brokers' loans would increase; this condition may perhaps be expected when profit-taking sales are made by customers who are beginning to be nervous of the high prices prevail-

[10] Twentieth Century Fund: *Stock Market Control*, p. 85.
[11] F. Macklup: *The Stock Market, Credit and Capital Formation*, Ch. VII.

ing, and who decide to withdraw their funds from the market and to hoard them or use them elsewhere. A similar increase in brokers' loans will occur when a new issue of shares is made and cash payments are not made in full for the shares; in these circumstances the payments made to the company which issues the shares go out of the market entirely, but the amount coming into the market is only the amount paid in cash for the shares. This amount is gradually increased, and the brokers' loans correspondingly decreased, by any further cash payments in respect of the shares coming from outside the market.

CHAPTER VIII

Management of Funds

Types of Assets

Assets are usually classified as fixed, current, and intangible; in most businesses land should be in a class by itself, for it is essentially different from the fixed assets with which it is usually classed.[1] Fixed assets are those which provide services over a period of time, not being consumed completely when used, but being subject to depreciation through use or natural causes, and to obsolescence through technological change, or through change in the scale of operations. Buildings, equipment and furniture are obvious examples. When a fixed asset is acquired, its length of useful life is estimated, and a proportionate amount of its cost is charged each year against operations. As the estimated life takes into account both depreciation and obsolescence, and because they cannot usually be considered separately, the charge is generally referred to as depreciation. Except in some special types of business, such as mining and agriculture, land is not subject to depreciation. It is used merely as the site on which business is carried on, and its services for this purpose are available in perpetuity.

Current assets are those which are completely consumed in providing the services for which they are acquired: e.g., fuel; or which are utterly changed by use: e.g., raw materials become finished goods, which are sold and are replaced by accounts receivable, which in due course are collected in cash, which, in turn, is used to pay for goods or services.

[1] This offers some support to the "Single Taxers". See G. B. Shaw: *The Intelligent Woman's Guide to Socialism and Capitalism*, Ch. 32.

Investments purchased for the purpose of making profitable use of funds which would otherwise be temporarily idle are current assets, but an investment in a subsidiary company, intended to be held for a long term, is in a class by itself and is obviously not a current asset.

The division between fixed and current liabilities is not clear cut. The division is not between those liabilities whose date of payment is fixed and those which are payable on demand; it is between those liabilities, already incurred, which must be met in cash in the ordinary course of business within a reasonably short time, and those whose payment need not or cannot be made within that time. Convention has established that, in general, a reasonably short time is a year. The division becomes, therefore, one between written obligations, such as bonds, whose date of redemption is a year or more distant, and all other ascertained liabilities. Bonds due within a year are not, however, always included amongst the current liabilities, and to include them may sometimes falsify comparisons from year to year.

Working Capital

Working capital is the difference between current assets and current liabilities. It gives an indication of the extent to which current liabilities can be met by cash payments in the ordinary course of business. The current assets are continuously changing: in the simplest form, cash is being used to buy goods and to pay for services which allow those goods to be sold for cash at a profit; if goods are bought on credit, then the cash is used to pay for goods previously acquired, while new goods are bought on credit; if goods are sold on credit, then there is a time lag before the cash from sales becomes available. Cash has to be used also to meet the fixed charges (interest, and sinking fund, if any, on bonds), to pay taxes, to pay for new fixed assets, and to pay out profits to the owners of the business. A large amount

of working capital provides a margin of safety to creditors; a cushion which takes up the shock of any interruption in the ordinary flow of business, or of any sudden drop in market prices, which will reduce the amount of cash which will become available. This margin of safety is of importance also to the business, to enable it to absorb the shocks mentioned above, and meet its obligations in spite of them.

A company which has a rapid turnover of goods, and which conducts its business largely on a cash basis can adjust itself very readily to changing conditions. A company which is involved in long manufacturing processes, which needs (e.g., for climatic reasons) to keep large stocks of raw materials on hand at certain times, and which enters into long-term buying contracts, may not only be affected by all price changes, but may also be more severely affected by falls than by rises in prices. Any company finding itself with a large inventory on hand with a down turn in prices has to guess whether the fall will be reversed quickly or whether it will continue; whether to restrict its purchases and reduce its prices so as to dispose of its inventory, or whether to try to maintain its prices and, perhaps, continue its purchases in the hope of helping to restore stability to the market.

Permanent working capital, the amount varying with the type of business, and with the size of the company, is the minimum with which the company can manage in "normal" times; although at best an estimate, it is yet a useful concept. Seasonal funds are the amount of ready cash, in excess of the permanent working capital, needed to meet heavy seasonal payments. If, after these payments are made, the cash is replenished quickly by corresponding seasonal sales, these funds may be acquired by bank loans. If, however, the cash is replenished slowly or after a long interval, or if seasonal needs arise several times during each

year, then the seasonal need may well be merged in a larger permanent working capital, and the excess may bring in bank interest when the seasonal need falls off. A company should try to retain sufficient flexibility so that it can raise additional cash to meet an emergency. For this reason it should keep certain assets free of encumbrance if possible, so that funds may be raised by mortgaging them. One of the difficulties of managing funds is to distinguish between an emergency, which will pass, and a fundamental change in conditions, which calls for an addition to the permanent working capital. The aim of careful management of working capital is to see that cash is on hand, or readily available, when needed for the ordinary business of the company.

Accounts Payable

The credit allowed on purchases is frequently fixed by the custom of a particular trade. The working capital remains the same whether purchases are bought for cash or on credit, but the amount of cash on hand is obviously greater if credit is granted. Accounts payable have the same effect as would a short-term loan. In some trades in which credit is habitually granted, discounts are allowed for the payment of cash for purchases, and a company has to determine whether to try to arrange to take advantage of these discounts regularly or whether to do so only when it has excess cash on hand. The maintenance of good credit standing with those supplying goods to the company in ordinary times may be of great service (although perhaps irrationally) in times of stringency.

Accounts Receivable

The granting of credit in respect of sales, the obverse aspect of the purchases resulting in accounts payable, may be governed largely by trade custom. If sales are not made for cash, then cash must be available from other sources. Normally, if the same length of credit is granted in respect

of both purchases and sales, the accounts receivable of a company will be greater than the accounts payable; if longer credit is granted in respect of sales, then again additional cash must be available from other sources. The cash position may be improved by offering discounts for cash payments for sales, or by discounting with a bank bills drawn on customers. Bills of this type are usually paid by the company before they fall due, and are not therefore presented to the customers by the bank for acceptance or payment. This is, in fact, a device by which a bank loan can be obtained on the security of accounts receivable; it may be an expensive source of funds if the bank rate is high, but it may be of considerable use in meeting a temporary stringency.

Care must be exercised in the granting of credit to customers, and credit information may be obtained from commercial services or from trade associations. Constant vigilance must be maintained over accounts receivable to reduce the incidence of bad debts and to prevent unwise increases in accounts which have become doubtful. Good judgment is of great importance in granting credit, and wisdom is not usually to be found in the automatic application of rules; excellent customers have been lost by many companies through bad judgment—at least, through what appeared to be bad judgment in the light of later knowledge.

Foreign Trade

The length of credit granted in respect of sales to foreign countries (other than U.S.A.) is usually larger than for domestic sales, first, because of the time taken in transporting the goods, and secondly because the goods are frequently purchased by merchants who may buy large shipments at a time and sell the goods gradually over a considerable period. The banks make provision to finance the shipment of goods to foreign countries. The company which ships the goods draws a bill of exchange on its for-

eign customer; the bill of lading, which carries the title to the goods, is attached to the bill of exchange which is then discounted by the bank, thus providing the shipper with cash. The bank then sends the bill of exchange and the bill of lading to its agent in the foreign country, and the goods are released to the foreign merchant against cash payment of the bill; or in instalments against part payments in cash, thus providing credit for the foreign merchant, and security for the bank.

A second method of financing foreign trade is a modification of that described above. The importer arranges a letter of credit with his bank in favour of the exporter, who draws a bill of exchange against the letter of credit instead of drawing on the importer. The importer's bank runs the chief risk, and exercises whatever control it thinks fit over the goods by holding the bill of lading. The choice of method depends on the relations between the exporter and importer and their respective banks, and between themselves.

Bank Balances

The keeping of bank balances constantly in excess of needs is obviously a wasteful use of funds, but any company which is subject to seasonal fluctuations is likely to have, from time to time, a larger bank balance than appears necessary. The temporary use of excess funds to bring in additional income is not always easy; the purchase even of government bonds for this purpose entails a risk which may be unreasonable in view of the very small return. The published accounts of some companies show, year after year, bank balances that appear superficially to be far greater than is necessary, but no proper judgment can be passed on them without knowing how those balances change during the year. This is an excellent illustration of the difficulty of attempting to analyse the finances of a company by making an examination of accounts rendered at yearly intervals; a

moving picture of what may be highly dynamic cannot be appreciated by looking at an annual snapshot.

Bank Loans

Something has already been said about bank loans in Chapter IV ("Short-Term Loans") and above ("Accounts Receivable", and "Foreign Trade"), but a little more needs to be added here. Most of the commercial and industrial loans of the chartered banks are made under "lines of credit". The borrower estimates the maximum amount he will need to borrow during the year and asks the bank to grant "a line of credit" to that amount; if it is granted the bank retains the right to cancel or to reduce the amount of the line, but this is a safeguard used, naturally, only when conditions change. A loan of this type is usually not secured by any mortgage of assets, and for this reason the banks expect their clients to make use of the services of only one bank at a time. Judging by the available literature, the commercial banks in this and some other countries expect loans to be "cleaned up" at least once a year. This is an aspect of the banks' constant anxiety for liquidity in their loans, and has probably had some undesirable and absurd results. A company being called upon to pay off a loan may borrow from another bank for the purpose, or a bank may expect a repayment of a loan at a time when it would welcome a loan under identical conditions to a new client.[2]

Banks appear (and perhaps quite naturally) to try to establish "principles", by which to judge whether a loan should be made, which may work reasonably well in ordinary times but which are no substitute for wide knowledge and profound analysis in changing circumstances.[3] It is easy for the critic to be wise after the event, and for the banks

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[2] See N. J. Silberling: *The Dynamics of Business*, page 484.

[3] "There is always a disposition to reduce the criterion to a cliché and then to apply the cliché as a criterion." R. B. Warren: *The Search for Financial Security*, p. 77.

to point to a long period of safety for all their depositors, but the fact remains that in difficult times some banks have made large loans which proved to be the reverse of liquid, and that they have also deprived business of loans which would have been mutually advantageous.

The interest charged for lines of credit appears to be more stable than other interest rates, and it is calculated on the amount of the actual loan. In the absence of an established line of credit, the banks usually charge interest on the whole of the loan granted for its duration, whether or not a portion of the loan is unused during part of the period. Another way in which the "real" interest is increased is by compounding interest at shorter periods than a year. The Bank Act limits the rate of interest that can be recovered on loans to 6% per annum, but the banks did not,[4] and probably do not, restrict themselves to this rate.

Decline in Bank Loans

In recent years the importance of bank loans as a source of funds for business has declined.[5] This has been partly the result of the retention of profits by companies (which will be discussed later in relation to dividend policy), and partly the result of their obtaining a larger proportion of the funds they need in a more permanent form, through issues of bonds or shares. A company has to decide whether it is best to borrow from the bank to cover needs which will probably last for only part of the year, or to cover these needs out of undistributed profits or by an issue of bonds or shares; obtaining what interest it can on surplus funds for part of the year. Apart from the greater security of relying on a permanent form, the company must consider the rate of interest charged by the bank, the rate of interest it can

[4] Report of the Royal Commission on Banking and Currency in Canada, Ottawa, 1933, pp. 32 and 72. The Commission recommended the abolition of this section of the Act; Parliament reduced the rate from 7% to 6%.

[5] J. F. Parkinson (Ed.): *Canadian Investment and Foreign Exchange*, Part II, Chapters XII, XVIII.

command on temporary excess funds, and the proportion of the year during which funds are needed. Statistics do not appear to be available to show typical interest rates on bank loans in Canada; in the United States it appears that the interest on bank loans has often been less than the yield on bonds,[6] but whether this is true in Canada, or whether the difference compensates for the advantages of bonds, is not known. The trend away from bank loans is probably seldom the result of careful calculations of this kind. The small business has probably retained a greater reliance on bank loans than has the large corporation.

Branches

The method of control of branches varies enormously, depending on the number and location of branches, the type of work they carry out, the history of their development, and the character of the managers. The branches of one company may be under rigid control by the head office, rendering daily statements and with no authority to make any cash disbursements. The branches of another company may enjoy almost complete autonomy, subject only to general direction of policy and the rendering of periodic reports. Generally speaking, all the branches of any one company should be subject to the same form of control; this makes possible greater efficiency in administration, particularly in dealing with reports received from the branches by the head office. The farther away the branches are from the head office, the greater the degree of autonomy necessary for the effective working of the branches. Foreign branches, each subject to local regulations and customs, and operating in various currencies, must obviously be allowed very considerable freedom, but the increase in speed of communication (particularly through airmail) has reduced this freedom to some extent.

[6] E. E. Lincoln: *Applied Business Finance*, pp. 415, 873.

Branches which do little more than receive and transmit orders to the head office have little need to become involved in the management of funds; nor have those branches which sell for cash standardized goods supplied by the head office. The granting of credit, or the re-packaging of goods on a large scale introduces complications; the purchasing of goods or the carrying on of manufacturing processes by branches inevitably involves them in the management of funds. The head office must, of course, take into account the funds of the branches in preparing an over-all picture of the company. In a properly controlled company with a number of branches of much the same size, no special difficulty is likely to arise, but if one branch of a company is normally providing a considerable portion of the total income, the management of that branch's funds becomes of prime importance.

Subsidiaries

What has been said above about branches is generally true of subsidiaries, but most subsidiaries are likely to be of the more complex variety and to enjoy considerable autonomy. Some subsidiaries may carry on business of a very different type from that of the parent company, and be subject to control only by the appointment of directors and, probably, in connection with major financial transactions such as the issue of bonds. Many subsidiaries, however, might function equally well as branches, but retain a separate legal entity in order to maintain goodwill associated with their names, or to give dignity to the senior officials, who may have held resounding titles before the parent company acquired its control.

Depreciation

The purpose of making a charge against operations for depreciation[7] is to spread the original cost of a fixed asset over its estimated useful life; the charge is usually cal-

[7] See the beginning of this chapter under "Types of Assets".

culated as a straight percentage of cost. Suppose that the cost of a new fixed asset is $10,000 and its estimated life is 20 years, an entry[8] will be made in the books each year as follows:

Dr. Profit and Loss	$500	
Cr. Provision for Depreciation		$500

If the estimate of useful life proves to be accurate, the provision for depreciation will amount to $10,000 when the asset is scrapped, and (assuming no scrap value) the following entry will wipe out both the asset and the provision for depreciation from the books:

Dr. Provision for Depreciation	$10,000	
Cr. Fixed Asset		$10,000

Apart from satisfying accounting technique, the only effect of making these entries is to reduce the profit which would otherwise be shown by $500 each year for 20 years. This reduction in profit has an important effect on the management of funds, particularly through the restriction of dividend payments. The company will have cash available to the extent that dividend payments are thus restricted.

If a company is floated to start a fresh venture and all its fixed assets are new, the cash that becomes available as a result of charges for depreciation will be considerable, and it may be used, almost without realization of its source, in expansion of operations. After a time the fixed assets will be scrapped one by one, and cash must then be found for the purchase of new fixed assets, and unless proper plans have been made, an acute shortage of cash may result. It would be a mistake, however, to consider the purpose of the charge for depreciation to be to provide for the replacement of assets, and there is no necessary connection between the provision made for depreciation of one asset and the cost of a new asset even if it is obviously a direct replace-

[8] Normally one entry will be made for the depreciation of all the fixed assets, but the entry shown here is in respect of the one fixed asset only.

ment.[9] What is necessary is that those managing the funds of a company should be fully aware of the sources from which their funds arise and the calls upon them which will inevitably be made.

Replacement of Machinery

The fact that the provision made for the depreciation of an asset has not been built up to the amount of the book value (*i.e.*, cost) is no reason why the asset should not be replaced. Consideration should first be given to the cost of operations using the new machinery compared with the old. If the machinery is replaced, the total cost of operations for a given volume of production will include materials, labour, power, depreciation, and repairs; if the machinery is not replaced, the total cost of operations for the same volume of business will include amounts for materials, labour, power and repairs (each of which may be the same as or different from the comparable amounts for the new machinery), but depreciation of the old machinery should not be included for this purpose. If, on this basis, replacement is advantageous, it shows that the rate of depreciation used for the old machinery has been too small, for the machinery is obsolete. The book entries made in the past to record an estimate of the depreciation must not be allowed to determine future policy; the costs that will be incurred in future production are the criterion, and the scrapping of old machinery cannot add to the costs of operating new machinery. This may be expressed more concisely by saying that replacement is desirable if the total costs of operations will be less than the prime costs of operations using the old machinery. The same argument holds good if the machinery has already been depreciated in full in the books. If a change in the capacity of the machinery is being considered, much more complex estimates must be made. Other fixed

[9] See Appendix E and C. A. Ashley: *Introduction to Accounting for Students of Economics* pp. 50-56, for a further discussion of depreciation.

assets, such as buildings, are subject to the same argument, but as they are less likely to become completely obsolete, attention is directed to them less frequently.

Budgeting

The continuance of a company in business depends upon its ability to meet its liabilities in cash as they fall due. In a small company carrying on single operations, the chief official (or someone working under his immediate control) has a very good idea of the cash position and how it is likely to develop, without resort to complex statements. In a large company divided into many departments, a treasurer, comptroller, or accountant receives reports from all parts of the company and integrates them so that a single, comprehensive financial picture may be available which will guide him in the routine management of funds, and which will also enable him to exercise control over departments. He is also in a position to supply the executive officers and directors with statements that will aid them in the determination of policy. The larger and more complex the company, the less is likely to be the autonomy of departments and the greater the authority vested in committees depending on statements prepared for them.

The word "budget" was originally used in finance for the annual estimate of revenue and expenditure presented to parliament; its use in business is broader and more varied. In a large and complex company, each department, with aid from the general and cost accounting departments, prepares its own estimates, which are examined by the comptroller and presented by him to the management with an over-all statement. The departments cannot, of course, work in water-tight compartments, but must be brought together in committees. The sales department may take the initiative by preparing an estimate of sales and of its expenses. This estimate must be submitted to the production department,

which prepares its estimates on this basis, and refers to the management any changes in capacity or lines of production necessary to meet these estimates. Purchasing, administration and other departments prepare their estimates on the same basis of sales. The comptroller prepares a budget proper, which is an estimate of the profit and loss account for the coming year, and also a cash budget or a statement of source and application of funds, from which he can estimate whether any new source of funds must be tapped or whether surplus funds will be available during the year. The cash budget for the year includes estimates of the total receipts and payments of cash resulting from the ordinary transactions of the company, and of payments which may be required or planned for interest on and redemption of bonds, dividends, and new fixed assets, and any anticipated receipts outside the ordinary operations of the company.

In addition to the annual cash budget, monthly estimates must be prepared, for cash must be available month by month to meet liabilities. The monthly cash budget may show in what ways savings may be effected by planning such periodic payments as interests and dividends to fit in with months when cash is normally available. It also shows the probable requirements of bank loans sufficiently in advance for proper arrangements to be made.

The preparation of budgets in a well-organized company should proceed smoothly and promptly, and regular checking of performance against estimates then provides an excellent form of control over departments. During the now comparatively rare periods, which are still sometimes referred to as "normal times", when business flows smoothly, and fluctuations are gentle, budgeting can be carried out efficiently and fulfill its purpose without great difficulty; at other times, and particularly in businesses which are subject to rapid changes, budget estimates may be very far from the reality that is unfolded. A capable management,

even without the gift of prophecy or the services of business forecasters, may make such use of the available statistical information that every turn in business does not take it by surprise and make nonsense of its budgets—a year, however, has now become a long period of time, and budget revisions each quarter may be advisable. Any company except the smallest may derive benefit from the use of budgets, but full-scale budgeting is expensive, and should be indulged in only by those companies which are so large and complex that its use is likely to effect savings commensurate with the cost.

Dividend Policy

A company can pay dividends only if it has in its books a sufficient balance of surplus (undistributed operating profit), or of distributable surplus (arising from an issue of no-par shares),[10] and if it also has cash available for the purpose. A great many divergent opinions have been expressed on the question as to what proportion of the profits of a company should be paid out in dividends and what retained with the business.[11] Investors are encouraged to buy shares by the prospects of dividends, often glowingly described, and may reasonably expect that a profitable company will pay such dividends as it can without running itself short of cash which is needed, or may shortly be needed, to keep the company going. A company may use its excess cash to redeem its bonds before they are due; this deprives the present shareholders of dividends while increasing their equity in the company. It may result in a great improvement in the finances of the company and enable it to weather a storm later, particularly if it is subject to violent fluctuations; it may, however, be disadvantageous to present and future shareholders, if the company is not subject to fluctuations, by ending the use of cheaply borrowed funds.

[10] See Chapter III under "No-Par Shares", 3.
[11] See Appendix D.

The profits of a company may be retained within the company and used for expanding its operations. This is detrimental to present shareholders, and whether or not it will prove beneficial to shareholders at a later date depends on the wisdom of the expansion. A great deal can be said in favour of financing an expansion by means of a new issue of shares rather than by the retention of profits. The restriction of dividends in order to redeem bonds, or more particularly, to expand capacity, tends to direct the attention of shareholders to possible rises in share values rather than to current returns, and this is probably unfortunate in that the search for capital gains (also encouraged by high income tax) has tended to accentuate stock exchange booms.

Few safe generalizations can be made on the question of dividend policy. No responsible management is going consciously to jeopardize the future of the company (and its own employment) by ill-advised dividend payments. The management of most companies is far more likely to err in the opposite direction, and to put forward such reasons for their policy as the creation of a reserve to meet adverse conditions in the future; the stabilization of dividends; the maintenance of wages. The published accounts of Canadian companies show, however, that a great proportion of the profits retained have been used in expanding capacity and in redeeming bonds, thus tying up these funds more or less permanently and precluding their use for the purposes named.

The retention of profits in liquid form for the purpose of equalization of dividends would be open to the objection that their temporary investment outside the company would subject them to needless risk through fluctuations in security prices (even of government bonds), and would bring in but a small return unless greater risks were taken. Shareholders might well feel that they should be left to determine for

themselves what to do with profits which could be paid out to them in dividends without detriment to the company. The claim is often put forward, without substantiation, that holders of common shares like to receive, or benefit from, a regular dividend. This argument is used more frequently to restrict dividends in good times than to maintain them in bad times; in fact, few companies appear to maintain dividends for any length of time when the regular dividend is not covered by current operating profits.[12] Retained profits are now the most important single source of funds for corporations.[13] This means that a great deal of expansion has taken place without anyone outside the management having the opportunity of considering any alternative use of the funds.

The dividend policy of a company should be determined by the management after a careful study of the amount of undistributed profit, the cash budget, and the sources of funds available to carry out the general policy of the management. The management should bear in mind the fact that the current tradition appears to lean heavily in favour of the retention of large proportions of operating profits, but that this tradition has by no means been conclusively proved by experience to be advantageous to either the shareholders or the company, and that some authorities consider that it is most undesirable from the point of view of shareholders, company and the general economy.[14]

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[12] *Ibid.*

[13] See Chapter VI under "Source of Funds".

[14] N. S. Buchanan: *The Economics of Corporate Enterprise*, Chapter IX, contains a comprehensive discussion of dividend policy.

CHAPTER IX

Scale of Operations

New Companies

Few new companies are now promoted to start entirely new businesses. New inventions and processes are likely to be brought to light by the research departments of large companies, or to be purchased and developed by them; the building up of a new community is likely to bring with it branches of companies (e.g., chain stores) to provide many of its needs. Many entirely new businesses do, of course, come into existence, but usually as sole proprietorships or partnerships, which may later become companies.

If a company is formed to take over an established business and a complete or partial change in ownership is planned, some expansion is likely to take place; indeed, the decision to expand may be the reason for the introduction of new capital and for the change in form of organization. Even if no expansion of capacity is intended, a reorganization of the plant may require additional capital, and if the securities of the company are to be offered to the public, one may be sure that more capital will be issued by the company than was necessary for the business up to that time. The same may be said of a company formed for the purpose of combining into one a number of companies which have previously been in competition, but that question will be considered in greater detail in the next chapter.

Horizontal and Vertical Expansion

The expansion of a company to enable it to carry on its existing lines of business, or similar ones, on a larger scale

is termed horizontal: e.g., the expansion of a manufacturing company to increase its capacity to produce the same or similar products from the same or similar raw materials. Vertical expansion results from undertaking an additional process either, at one end of the chain, to produce the raw materials of the existing processes or, at the other end of the chain, to use the finished products of the existing process as raw materials of a further process. A company may also be said to expand, in a limited sense of the word, when the book value of its assets is increased although its facilities remain the same. Companies seldom contract their capacity except occasionally by "shedding" subsidiaries, as was done by Vickers Ltd. in the 1920's.[1]

The principal advantages of vertical expansion are two in number. First, the saving in transport and packing costs when the processes are carried on by contiguous plants, and in some processes (particularly in iron and steel) saving of fuel by carrying materials hot from one process to the next. Second, the saving in buying and selling costs between the various departments. Further, a well-integrated plan for the whole process may prevent over-production at any particular stage. Vertical expansion benefits in the same way as does horizontal expansion from some of the savings described below (e.g., management) but not from some of the savings included under division of labour.

Reasons for Expansion

Expansion may take place not as the result of careful planning but for no better reason than that funds are available[2] and that the business community has a general belief that expansion is a good thing; that the only alternative to expansion is regression. This belief is founded in part on the experience of a period of rapid change; a change partly

[1] What E. A. G. Robinson: *The Structure of Competitive Industry*, p. 110, calls "vertical disintegration".

[2] See Chapter VIII under "Depreciation" and "Dividend Policy".

dependent on and partly the cause of a rapid growth in population and the exploitation of new natural resources; a change which is proceeding now at a much slower rate. Changes in the age distribution, in the distribution of income, and in the material standard of living (particularly in "backward" countries) may now justify expansion, but thoughtful expansion should take the place of the automatic and exuberant expansion probably appropriate to an earlier time.

To determine the motives of the management which decides on expansion is difficult, for people are not more likely in business than in other walks of life to wish or be able to formulate their motives honestly. Reasons are likely to be sought after the effects of actions are known, particularly in smaller companies dominated by one or two men. The idea, conscious or not, of personal aggrandizement and power is one of the reasons for expansion that is described by most of the writers on this subject. In addition, the high official of a large company is much more secure in times of depression; a large company may be reorganized when a small company is wiped out completely. An expansion which involves a public issue of securities may have as its chief reason the profits which fall to promoters and to distributors of securities. The reason for expansion assumed by many economists in their analysis is the expectation of larger profits; certainly, if expansion seldom resulted in larger profits, it would not take place so frequently, whatever might be the personal motives of the management.

Size and Profit

Various attempts have been made to show statistically the relation between size and profit,[3] with a not very definite conclusion that large companies earn proportionately larger profits than small companies in the same line of business;

[3] Guthmann and Dougall: *Corporate Financial Policy*, p. 555 fn. Lincoln: *Applied Business Finance*, Ch. XX, arrives at more definite conclusions.

but that the advantage decreases as size increases beyond a certain point and that, beyond a further point, an increase in size brings a lowering of the rate of profit. No valid reasoning could be put forward on this evidence that companies would do well to aim at any particular approximate size with a view to maximization of profit. So much depends on the determination of size, profit, and rate of profit on total investment (to say nothing of the past history of individual companies), and the accounting technique in use is not sufficiently standardized to create confidence in the figures available.

The Canadian statistics are not as complete as those of the United States, largely because the government is so coy in dealing with income tax returns, but there is ample evidence that small businesses still predominate in numbers and that the advantages of size are not sufficient to destroy them. Many small businesses fail and cease to exist; a year or two of losses will effect this while a large company drags on through a reorganization involving a writing down of capital. The reason for this is that the small business is probably run by a man who depends on profits for his livelihood while the large company is supplied with funds from a large number of bond and shareholders who, even if they feel the loss of income severely, can do little about it. There are approximately 27,900 manufacturing establishments in Canada of which 14,800 have a total production of less than $25,000,000 a year, while 278 have an annual production of over $5,000.00[4]. The same conclusion is reached as to retail selling: 52% of the retail outlets have annual sales of less than $10,000, but are responsible for less than 9% of the total sales.[5]

[4] *Canada Year Book*, 1945, p. 425.

[5] *Ibid.*, p. 613.

Limitations on Size

As will be shown later, advantages along various lines can be expected from large-scale operations. In some businesses these advantages are so great that small-scale operation is virtually impossible; in other businesses these advantages are so slight that they are easily overweighted by other considerations. The efficient and economic working of most public utilities and of blast furnaces, for instance, requires a certain minimum size; on the other hand certain services and professions gain little, if anything, from large-scale operations, and the disadvantages of large size through a decrease in personal relations, are obviously great.

In general, transportation costs are the most important factor in limiting expansion. The economic centralization of production in one spot depends on the savings from large-scale production exceeding the additional costs of carrying raw materials and finished products. The economic concentration of control over units operating in many different localities also depends, although not so directly, on rapid communication. A second limiting factor, fairly generally admitted, is to be found in management; this point will be discussed later.

Methods of Expansion

A great many large companies have been built up from small beginnings by gradual expansion through the retention of profits. This is still the way in which a closely held business expands; it is a method also used by companies whose shares are widely distributed, but doubt has been expressed[6] on the desirability of this. If a company is adapting itself to a gradually expanding market, gradual expansion of its operations is obviously sensible, although the expansion in any business using machinery must necessarily be somewhat "lumpy". Critical points will arise from time

[6] See Appendix D.

to time in a gradual expansion, when a reorganization of plant lay-out will be necessary to prevent internal transport costs from exceeding the additional profits expected from further expansion. At these points the question will arise whether the plant has reached almost an optimum size, and whether further expansion should consist of the setting up of a new unit of production. Although expansion may take place gradually, it need not be haphazard; it can be planned for some years at a time. A company cannot operate under the most advantageous conditions every year, and if it intends to expand, the plant should be so designed that the expected expansion does not result in cramped quarters.

Expansion may take place through the purchase of other businesses, and by the setting up of subsidiary companies. If the expansion takes place at a new site, some of the advantages discussed below will not be available; in the extreme case the advantage, if any, will be confined to management and finance. Whether a particular advantage will accrue under any specific heading is so obvious that the point will not be laboured in the following discussion.[7] The advantages which result from a reduction of human effort or a more economical use of labour and materials should benefit the community at large; those which result from an improvement in the bargaining position of the company in relation to other companies will benefit that company alone.

Division of Labour

The division of labour, or the specialization of workers on the various tasks which make up a complete process, can be carried further and further as size increases, up to the point at which no further subdivision of tasks can be made; each worker is doing one indivisible job. The skill and rapidity of the worker are developed so that the output

[7] See Marshall: *Principles of Economics*, Book IV, Chs. IX and XI, and *Industry and Trade*, Book II, Chs. III and IV for an excellent discussion of the influences of size on production.

per worker is much greater than if each carried out the whole process. The invention of complicated machinery has reduced the amount of skill required and has quickened the pace of production; mechanical means are used to carry material to machines and workers along a "production line". As long as the reduction in total wages is greater than the added cost of operating the machine, the introduction of the machine is profitable, and it follows that an increase in the rate of wages is an incentive to the invention of new machines. The increase in the size of companies and the specialization of work have aided the development of labour unions; the former has brought the need for an adjustment in bargaining power, and the latter has brought together specialists with common interests. A small company cannot carry division of labour and provision of machinery as far as a large company, and it is also under the disadvantage that union rules or labour legislation may make impossible the switching of workers from one job to another, or the employment of a handy man for repair work.

The advantages of division of labour are most striking in a plant engaged in mass production of a standardized article; they are to be found, however, in every branch or department of large companies. All the work in purchasing, stores, and sales departments, and even in management may benefit, and the use of mechanical aids and division of labour in accounting departments may approach that in the plant itself.

Overhead Costs

The large company which has introduced mechanical means of production on a large scale is faced with a particular problem: the necessity of using its equipment at all times as near to its capacity as possible. An idle machine continues to depreciate, and the greater the output the less the cost of depreciation per unit of output. In so far as

unemployment insurance is added to wages, an idle worker is subject to a similar argument, but this is not sufficiently important to make up for the rigidity which goes with mechanization. The moral of this is that a company should not expand its capacity immediately the market widens, without considering the probable market over the whole of a trade cycle or fluctuation; nor should it forget that other companies in the industry will capture some of the expanding market.

Apart from depreciation of equipment, there are other fixed charges such as rent, heat and lighting, and management costs. If it can expand its capacity without materially increasing its overhead costs, a company will obviously be reducing its unit cost; expansion will eventually reach a critical point at which a marked increase in overhead costs will occur if expansion is carried further. To reduce the burden of these overhead costs a company will strive to use its facilities to full capacity.

Because of the greater relative importance of equipment in large-scale operation, the burden of depreciation of machinery is often more important than that of other overhead costs in differentiating between large and small-scale production, and the urge to cut prices in order to maintain production as near to capacity as possible may therefore be more marked in large than in small companies. It is also more marked in industries equipped with costly equipment than in those whose equipment is less costly. A cut in prices is not always readily restored when demand increases.

A small company may be more flexible than a large company in adapting itself to new conditions and to new lines of production, particularly if they do not require costly machinery. This is partly due to the concern with overhead costs in the large company, but also to the fact that a change in policy can be considered and determined more easily in a small company.

Technology

The two previous sections have dealt with the economies resulting from technological improvements, but a little more must be added as to the advantages of the large company, and the limitations of those advantages. A large company is more likely to develop new improvements for itself than is a small company. It will patent its own improvements or purchase patent rights from others; it may also use its financial resources in fighting for or against patent rights, to the detriment of the small company. New machinery may be very costly, and a small company wishing to expand by its use may not be able to command the funds required.

In some industries the most efficient size of a unit of production (a machine, or a line of machines) may not be very large, and increased production may be possible only by a multiplication of such a unit. A large company then has no particular technological advantage over a company which is just large enough to operate one unit. The same is true if the increase in the size of one unit beyond a certain point brings with it only very slight technological advantage.

Large-scale operation enables a company to set up research and testing departments staffed by well-trained workers; in some lines this advantage has been modified by the research work done by trade associations or by public or semi-public bodies, the results of which are available to all units in the industry.

The use of by-products is much more economical under large than small-scale operation. In a small plant, the by-products may be disposed of as refuse because transportation and other charges make it impossible for them to be disposed of to any other business which has a large-scale alternative source of supply. An intermediate size may make it profitable to collect and sell the by-products. In a large plant, by-products may be produced in such large quantities

that a separate department may be set up to process them.

Materials and Services

The purchasing department of a large company may benefit from division of labour, and its cost should be a smaller proportion of total cost than in a small company. In its acquisition of materials, a large company may be granted a reduction in price because of the quantities purchased; the seller of the materials grants the reduction because of the savings he experiences in dealing with one large order compared with a number of smaller orders for the same total quantity. Large companies in some lines of business may be of such importance to individual producers that they can force prices down, and thus obtain an even greater advantage from their size.[8] The advantages described above are not confined to materials, but may apply to all the relations of the company with the business world, transportation being of particular importance.

The inventory of materials required by a large company should be a smaller proportion of purchases than in a small company; the larger the company the greater the flexibility in the use of materials between departments and processes, and the less the reserves necessary for smooth working. This is particularly noticeable in an industry in which the same materials are used for many different processes (e.g., the chemical and the light metal industries), and is of importance mainly when the manufacturing processes of the company are concentrated in one place.

Selling

The advantages of large-scale operations in selling come from three sources. The first is the appointment of specialized salesmen with technical knowledge; the second, the provision of services after a sale has taken place; and the third, somewhat the reverse of the first, the use of one

[8] Report of the Royal Commission on Price Spreads, p. 221.

salesman for a large variety of goods. The importance of one or another of these advantages varies from industry to industry.

A company operating on a large scale can afford to make each salesman responsible for only a small area, with savings in time and in travelling expenses. The advantage in foreign sales is particularly marked, for the small company cannot afford direct representation in foreign countries and must make whatever sales it can through agents, while the large company can operate foreign branches, or appoint a representative to the staff of agents who do no selling for the company, but who handle the storage and transportation of goods, and keep records. A further advantage accrues to the large company in the division of labour in the sales department and through the control of credit by a credit department.

FINANCE

Public issues of bonds and shares can usually be made more easily by large than by small companies; issuing houses find it easier to distribute the new securities of large companies. In addition, the costs of making a new issue of securities do not increase proportionately with an increase in the size of the issue. Small and closely held companies seldom make bond issues. As far as short-term loans are concerned, large and small companies are in much the same position, except in so far as large companies tend to include bank directors on their boards of directors, and may therefore, at the least, have special opportunities of stating their case. There is some evidence[9] that small companies are not usually in as strong a liquid position as large companies, but this may mean that they are able more quickly to make good use of surplus funds. The failure rate of small companies is, however, greater than for large companies;[10]

[9] C. L. Merwin Jr.: *Financing Small Corporations in Five Manufacturing Industries* (New York, 1942), p. 11.

[10] *Ibid.*, p. 2.

this may be partly due to the probability of bad times bringing a reorganization rather than a "failure" to large companies.

Government regulations, and the returns called for under them, increase the overhead costs of business, and as these costs do not increase in direct proportion to increases in size, they bear more heavily on small than on large companies. In the United States, taxes also appear to bear more heavily on small companies.[11] How important these considerations may be in Canada is difficult to estimate.

Management

Large-scale operations bring both advantages and disadvantages in management. The advantages are derived from division of labour, specialization by experts, and the possibility of using to the full the ability of those engaged in management. The statement of these advantages takes up little space, and they require no elaboration. They are of considerable importance, but the savings they effect would seldom of themselves justify expansion. A further advantage which might be expected is not always seized upon: the ease with which nepotism could be avoided. The large limited company becomes more and more impersonal in its relations with people, but that does not always apply to the close relatives of high officials. The succession from father to son in a small company is often tied up with ownership of shares; in a large company it is a measure of the power exercised by individuals, and, often, of their lack of judgment in matters which concern them personally. A general manager may readily deceive himself into believing that his son is the obvious person to be trained to succeed him. The large company has the opportunity of seeking promising young men and of training them deliberately as replacements for senior positions; an opportunity that is

[11] C. C. Abbott: "Small Business A Community Problem" (*Harvard Business Review*, Vol. XXIV, No. 2).

denied to the small company. The death or illness of one individual in a large company should have little effect on the efficiency of management, whereas its effect in a small company may be disastrous.

The disadvantages of large scale in management are mostly concerned with ultimate control. Direct supervision by one person of the whole of the operations of the company is not possible, and personal relations between those in control and the "workers" become more and more tenuous. Although sound judgment may be reached by consultation between experts, it is not rapid, and rapid decisions in making, modifying, and (sometimes the most important) reversing policy may be of enormous advantage. Most of the objectionable features of bureaucracy, which are commonly supposed to be found only in government departments, are to be found to some extent in large companies. In fact, they are the almost inevitable penalty attached to the benefits of large-scale management.[12]

The functions of management are two: to determine policy and to see that it is carried out as efficiently as possible. In a large company, the second of these is of prime importance, for the advantages resulting from large-scale operations in all the various departments can be achieved only if the business is running smoothly. The function of management is therefore to plan and to integrate. In a small company the hierarchical system of management is almost inevitable, but in a large company this system is inefficient, and the line and the staff method (the method used in the army) is likely to be the best.[13] At some point in the expansion of a company, the benefits resulting from a change in the system of management are likely to exceed

[12] W. E. Phillips: "Some Experiences in the Administration of a Crown Company" (*Commerce Journal*, April, 1946) contains an interesting discussion of management problems.

[13] See P. S. Florence: *The Logic of Industrial Organization*, pp. 114-143, for a full discussion of this question.

the addition overhead costs involved.

Lloyd George once stated that, in his experience, a man who could not express himself clearly had a fuzzy brain. He was thinking of people whose occupations required that they should express themselves frequently in writing. In small businesses the head official may not infrequently be a man who may be able to give intructions clearly, but who is quite unable to explain reasons or argue rationally. Such a man may be very successful, but he has no place in a large company in which planning and integration must necessarily be the result of co-operative intellectual effort.

Optimum Size

Beyond a certain point increase in scale of operations is subject (under all the headings listed above) to diminishing returns; whether, in each department, there is an optimum size beyond which returns actually decrease, and whether there is an optimum size for the business as a whole is open to argument.[14] The idea of an optimum size is, of course, entirely theoretical, for conditions are not static enough for practical application, and the cost of employing a staff to try to determine the optimum size would be greater than any savings likely to result.

In the use of machinery and equipment generally no particular advantage results from an increase beyond a certain point. In management, it seems probable that there are limits to size beyond which, even with managers of exceptional ability, the task becomes too great for the senior officials, particularly when expansion has brought wide variety into the lines of goods produced. The task is not made easier by the tendency of such officials to dissipate their time and energy by joining the boards of directors of other companies with a wide diversity of problems.

[14] E. A. G. Robinson: *The Structure of Competitive Industry* and Florence: *op. cit.*

CHAPTER X

Combination and Monopoly

Definition

In the last chapter, the savings that may result from large-scale operations were discussed. Large-scale may be the only economic or only feasible scale of operations (e.g., the manufacture of a new article to which mass production is immediately applied; the atomic bomb); or it may be the result of expansion of a company; or it may be the result of combination. Combination may be defined as the relation between two or more units in a trade or industry intended to effect savings or to reduce competition. It may take the form of a loose, informal and implicit association of units which retain their identity and complete autonomy; or of a complete merging of units into one single unit.

Informal Agreements

One of the most frequent subjects of agreement is the price at which goods or services may be offered for sale. Prices may be fixed and maintained by tradition (e.g., certain professional fees, particularly in England); by tacit agreement or the following of the lead of the largest unit (which is commonly supposed to be true of the oil companies in Canada); or by the exchange of information on current prices and proposed changes, frequently through a trade association, which may preserve the anonymity of the companies when handing on the information.

A division of territory may be made informally by companies, particularly if there are only a few companies concerned, for such a division between more than two or three companies would almost certainly have to be formal. Two

companies operating from different centres may have built up a virtual monopoly in their particular areas, and each may decide not to invade the territory of the other unless provoked: armed non-belligerency, in the recently current jargon.

Formal Agreements

Between informal agreements at one extreme and change in ownership at the other, formal agreements leave the companies entering into them completely free except in so far as they contract to do or refrain from doing certain things.

The enforcement of agreements is not easy. In the first place, any attempt at enforcement may raise the suspicion of illegality; in the second place, the public looks with disfavour on such agreements, and secrecy is impossible if actions are to be fought in the courts. Under some agreements each company concerned is required to deposit a fairly large sum with a trustee or a trade association, which sum is forfeited if a committee is of the opinion that the company has broken the agreement. This may make enforcement successful unless any company is under a particularly heavy strain, and is prepared to lose its deposit in order to obtain advantage from breaking the agreement.

(*a*) *Prices.* The fixing of prices can be effective only if the companies entering into the agreement are responsible for a sufficiently large proportion of the total sales to ensure that any outside the agreement will follow their lead; the fact that some companies may not be parties to the agreement is a source of weakness, and they may refuse to follow the lead at a critical moment. Agreements may be made at meetings called for the purpose (e.g., shipping conferences) or as a regular part of the business of trade associations. To be in any way effective the agreement as to price must cover such things as packing, service after sale, terms of credit, and discounts.

(*b*) *Output.* The fixing of prices may be an effective way, although not always,[1] of reducing competition and increasing profits, but the breaking of such an agreement is not easy to detect. An agreement to fix and control output reduces competition further (it usually includes the fixing of prices), and offers greater security to all the companies. Under such an agreement each company is allotted a proportion of the total sales[2] or a percentage of its capacity[3] for a period of years. If a company exceeds its quota of sales it pays a penalty which is divided between the companies falling below their quotas. Difficulties arise in fixing the original quota for each company, and such difficulties may be accentuated when the agreement is revised, particularly if the revision falls due when trade is good, for progressive companies are not content to remain in a static condition, and an unprogressive company may be difficult to convince of its shortcomings.

(*c*) *Marketing.* A much greater control of output may be effected by setting up a common selling agency or central office to which all orders are reported. The office allocates the orders so as to carry out the agreement, and in making the allocation bears in mind the transport costs. Savings may thus be effected in transport and selling costs, and perhaps in advertising, and the benefits are thus shared, directly or indirectly, by the community at large. Secrecy as to the existence of the agreement is, however, much more difficult to maintain.

(*d*) *Division of Territory.* An alternative to control of output is found in an agreement to divide the market into exclusive territories for each of the companies. Such an agreement must necessarily include an agreement on price,

[1] See report by Professor C. A. Curtis in the Report on the Alleged Combine in Tobacco Products.

[2] Report on the Alleged Combine in Paperboard Shipping Containers.

[3] V. W. Bladen: *Introduction to Political Economy*, p. 173. Chapter VI as a whole gives an account of the Newsprint Industry and the agreements attempted in it.

but the prices need not be identical, for transport charges can be added safely, as they cannot when competition is free. Some method must be devised of handing on orders addressed to one company to the appropriate company, and a central office may be used for this purpose. To maintain the appearance of competition secrecy must be preserved, and each company keeps a stock of its "rivals'" labels on hand. The book-keeping is most conveniently carried on at a central office. Savings in transport and selling costs are effected as in the control of marketing discussed above.

Limitations

Agreements are not likely to be successful over any period of time in connection with any goods which, in the absence of agreement, are likely to be subject to wide fluctuations in price. For instance, price fixing by agreement between producers of agricultural products will fail because of the impossibility of regulating the volume of output of goods depending on climatic conditions, although prices of these goods may be fixed by governments. Nor are agreements easy to make and maintain in respect of goods which cannot be easily and accurately described and measured. Another way of expressing this is to say that standardized products or goods which can be accurately graded (e.g., metals, oil, chemicals, and machine products) are those best suited to agreement. Some of these, however, are produced with high overhead costs, and price agreements made in good times may break down in bad times owing to the pressure of overhead costs. On the other hand, bad times may be the cause of an agreement being made, particularly an agreement as to output. Each company is prepared to suffer the burden of overhead costs, resulting from operating at less than capacity, in order to escape the pressure to reduce prices in an attempt to increase its share of the market.

Trusts

Although not now found, trusts are worth mentioning because they were possibly the most effective method, particularly in the United States, of controlling prices and of obtaining other benefits of combination, within the law of the day yet obviously flouting its intention. Each of the companies in the trust appointed an identical body of men as trustees to manage the company. Public opinion in the United States, perhaps more than elsewhere, was strongly opposed to the formation of large combines at the time, and this dislike was strengthened by and concentrated on the trusts. G. K. Chesterton described a trust as a large organization which arouses distrust.

Interlocking Directorates

Companies which have one man in common on their boards of directors may be entirely unaffected by that fact; the companies may be entirely different in operations and have no business dealings with one another. If two or more companies in similar lines of business have identical directors, the same effect as that of a trust is produced. Between these extremes are to be found many examples of groups of companies, partly in competition or with many inter-company transactions, which share several directors or officers. The extent to which they benefit by reduced competition, by savings in conducting their inter-company transactions, or by the concentration of power in dealing with other companies, probably varies enormously from group to group, and is difficult to estimate.

In the United States the interlocking was effected largely by directors who were members of financial houses, and legislation was passed to limit the extent to which these houses could build up "empires". In Canada some of the banks are interlocked with trust companies, and many other

examples can be cited.[4] A few names recur so frequently in lists of directors of large companies as to arouse the suspicion that, if the directors do their job, this concentration of power may have a definite relation to the whole problem of combination.

Exchange of Shares

Companies may exchange shares or one company may buy shares in another on a scale sufficient to establish common interests without any common control. This is usually the prelude to a closer association in the future.

Holding Companies

A holding company is one which owns a sufficient number of shares in other (subsidiary) companies to be able to control them. The holding company may have no function other than that of holding shares in subsidiaries, or it may also be an operating company itself.[5] A holding company may own all the shares of a subsidiary, but a very small proportion of the shares may give effective control unless a strong opposition holding engineers a revolt.[6] Less than fifty per cent of the shares gives a stable control, and the use of proxies reduces the proportion required in normal times to a much lower figure.

The managements of some holding companies in the United States have, by "pyramiding", built up control of enormous assets while holding only a very small capital investment in the holding companies, as was done by the Insull group. The top company holds the minimum number of shares necessary to control two or three companies; these companies, themselves holding companies, control with a

[4] For instance: Dominion Textile Co., Montreal Cottons, Paton Manufacturing Co., and Penmans, in the textile business.

[5] St. Lawrence Corporation is a pure holding company; one of its subsidiaries, St. Lawrence Paper Mills Co., is an operating company holding a controlling interest in Lake St. John Power & Paper Co.

[6] See Chapter II under "Domestic Arrangements".

minimum holding of shares more companies; at the bottom of the pyramid are the large number of operating companies. No evidence of this is found in Canada, but under a different management, the pattern might be faintly discerned in British Columbia Power Corporation.

Holding companies, even if they own most of the shares of subsidiaries, retain a considerable amount of flexibility, for the subsidiaries all retain their legal identity, and the holding company can gradually divest itself of the shares it holds in any subsidiary, or dispose of its holding outright to other interests.

Mergers

The extreme form of combination is to be found when two or more companies consolidate their interests by merging into one company, which may be one of the companies forming the merger, or a new company set up for the purpose. The usual procedure is for the shareholders of all the companies to be offered shares in the company which is to carry on, in exchange for the shares they hold. If the majority of shareholders accept the offer, a method has usually been found to bring in the recalcitrant minority, and is provided in Section 124 of the act; when this has happened, the companies which have ceased operations go into liquidation and cease to exist as legal entities.[7] Even this form of combination is not irrevocable, for a company may sell a portion of its assets, perhaps a unit which used to be a separate company, to another company.

Mergers are more likely to be found in horizontal than in vertical combination, and the reverse is true of holding companies. This is because more complete centralization of control and of operations is possible when only one line of business is carried on, and because greater autonomy must be granted to units in a vertical combine owing to the fact

[7] See Appendix F, for an account of the formation of Dominion Textile Co.

that each unit has problems peculiar to itself. In a horizontal merger, a contraction in the total output of the group may be effected by closing down the least efficient unit instead of by reducing the output of all, as would be the method used under an agreement. The merger is, from this point of view, more advantageous.

Motives

Some of the motives leading to the formation of combines are the same as those discussed in the previous chapter when dealing with expansion: promoters' profits, personal aggrandizement, power, and savings resulting from large scale operations. To these must now be added the reduction of competition and the prospect of semi-monopolistic profits, through combination. From one point of view the expansion of an industry by a combine is preferable to expansion under freer and more competitive enterprise; the expansion can be planned to avoid wasteful duplication of capacity.

Prosperity and Depression

Combines which are formed in periods of prosperity are most likely to be initiated for selfish purposes which are likely to be detrimental to community interests, except that the community may benefit indirectly and accidentally. A merger in good times probably aims chiefly at promoters' profits, with increased operating profits as a result of decreased competition as a secondary aim. An agreement aims chiefly at increased profits as a result of decreased competition, with the maintenance of prices at the end of the boom as a secondary aim. Such an agreement may be difficult to maintain at any time when any of the companies concerned has unused capacity, and is likely to break down at the first breath of adversity.

In bad times, mergers are not frequent, but a large company may have funds available to buy out and close

down a troublesome competitor. Agreements made in bad times are aimed at the reduction of price competition, and are likely to extend to control of output. Such agreements may break down as soon as conditions improve, because one or another of the companies wishes to regain its freedom in the hope of capturing a larger proportion of the expanding market than that allotted to it under the agreement.

Agreements are made to deal chiefly with conditions as they are at a particular time, and strains are obviously likely to develop as fluctuations in business occur. Any considerable change may break the agreement, but the companies concerned may shortly be brought together in a new agreement more appropriate to the new conditions.

Marginal Businesses

Combines are sometimes frustrated in their efforts to control prices, or to restrict output so that prices may be raised, by the entrance into the market of marginal producers who can operate profitably only if prices reach a certain height. They may mostly be legitimate business ventures, but occasionally they may be only using their nuisance value for blackmailing purposes. In an industry which requires a large investment in capital equipment, a combine need fear little from new units coming into the industry whenever prices reach a certain height; old units which have ceased operations may start up again, but they can be bought and their equipment scrapped at a favourable moment. In an industry which requires only a small capital investment, nothing can be done to prevent new units coming into the industry as soon as they see the chance of profits; an industry of this type can never yield monopoly profits, and agreements in such an industry are likely to be very unstable.

Objections to Combines

One of the most often repeated statements of Adam

Smith is that "people of the same trade hardly meet together for merriment or diversion but the conversation ends in a conspiracy against the public or in some contrivance to raise prices." Nevertheless, large-scale enterprise has brought with it many advantages to the whole community, and some of these advantages have been most economically achieved through combination. Quite apart from questions of taste and of the use of leisure, the material standard of living in western civilization has been raised enormously by large-scale production; and, judging the economy as a whole, a great deal of wasteful competition has been avoided by combination.

Monopoly is almost certain to be abused unless rigidly controlled, and is particularly dangerous when engaged in the production of goods the demand for which is inelastic: goods in common use for which no substitute is readily available. Combination carries with it the threat of all the abuses of monopoly. To prevent the abuses of combination by attempting to maintain competition may be very wasteful in some lines of business, but may be successful if there is room in the industry for several companies operating near to optimum size. The alternative is control of combines after they have been formed; methods of control are discussed below.

A further objection to combines, or to any very large-scale enterprise, is that they can exercise economic and political power to subserve the interests of a comparatively small section of the community and undermine the foundations of democracy.[8] The power and the direction of funds of corporations are concentrated into the hands of a management group by the divorce between ownership and control. If the groups in each industry become smaller and their power

[8] See A. Schwietzer: "Big Business and the Nazi Party in Germany" (*The Journal of Commerce of the University of Chicago*, Vol. XIX, No. 1); Berle and Means: *The Modern Corporation and Private Property*, p. 357.

becomes greater through combination; if groups in different industries co-operate and combine; if newspapers are drawn into the inner circle; and if corporation funds are used on a large scale to corrupt public officials and members of parliament, then a new form of dictatorship may be imposed upon us. How to receive the benefits of large-scale enterprise and combination while avoiding the dangers is one of the most important questions of the time.

Monopoly

Even in the industries which are best suited to achieve the advantages sought by combination, monopoly is a relative term. A company may enjoy what appears to be a monopoly position in a certain area, but as it increases its prices the protection that transportation charges have afforded it becomes less and less; for the same reason a country with a tradition of free trade is not so concerned about monopoly (short of world monopoly) as is a country with heavy protective duties.

Some enterprises can be carried on economically only as monopolies. These are enterprises requiring a very large capital equipment for production and distribution in which competition would be very wasteful (e.g., most public utilities); or those in which the cost of service to individuals varies enormously, but the general interest requires that the service shall be commonly available at no great variation in price (e.g., the postal service). More types of business may be added to those in which a monopoly is desirable through changes in technology or in the social outlook.

Certain industries have started with monopolistic tendencies arising from patent rights and the necessity for extensive capital equipment, but may be subject to competition from rival processes. Rayon, aluminum and the atomic bomb are good examples. In other industries monopoly may be approached as a result of a process of combination and

attrition based on technological changes which make it impossible for small companies to compete with large-scale producers. The electrical machinery industry may be an illustration of this type. A monopoly need not be the result of combination; it can result from the triumph of one company over all its competitors.

Regulation

Combines and monopolies are almost always operated by corporations; corporations are creations of the state, granted unusual privileges which set them apart from the free enterprise of individuals and partnerships. Apart from these considerations, the social good requires that combines and monopolies should be regulated by the state; in particular, it is intolerable that the supply of essential commodities or services should be subject to unrestricted control by one or two small groups of people, who may be actuated by the profit motive in an extreme form. The Combines Investigation Act (with amendments) refers to

> "A combination having relation to any commodity which may be the subject of trade or commerce, of two or more persons by way of actual or tacit contract, agreement or arrangement having or designed to have the effect of
> (a) limiting facilities for transporting, producing, manufacturing, supplying, storing or dealing, or
> (b) preventing, limiting or lessening manufacture or production, or
> (c) fixing a common price or a resale price, or a common rental, or a common cost of storage or transportation, or
> (d) enhancing the price, rental or cost of article, rental, storage or transportation, or
> (e) preventing or lessening competition in, or substantially controlling within any particular area

or district or generally, production, manufacture, purchase, barter, sale, storage, transportation, insurance or supply, or

(f) otherwise restraining or injuring trade or commerce."

Any organization set up or any arrangement imposed by the federal or provincial governments is presumably supposed to be subject to regulation by these governments and is not therefore subject to the act.

Control of Monopoly

Monopolies are set up by governments (federal, provincial or municipal) usually to provide the services of a public utility: any other form of monopoly is likely to be indicted at common law as a general restraint of trade and is subject to control by the Combines Investigation Act. There are three forms that government control may take.

(1) *Franchise.* An exclusive franchise may be granted to a company to supply services or commodities to the area within the jurisdiction of a particular government. The franchise is usually for a fixed period of time, with the understanding that it will be renegotiated at the end of the period. It provides that proper service shall be supplied to the people in the area, and sets out a formula by which prices are to be determined. They may be determined, after negotiation, by the government or a public utility commission; this method has resulted in the United States, where it is common, in protracted and costly argument. They may be determined automatically by a sliding scale relating prices to dividends or to profits; a method used with comparatively little friction for some companies in Canada. Capital issues and extensions of operations may be subject to similar control.

The Consumer's Gas Company of Toronto has a provincial franchise with no time limit attached, but the terms

can be changed by Act of the Ontario Legislature. The company is prevented from making new issues of shares to existing shareholders; if it wishes to issue shares it must offer them for tender. The dividend rate, on the only class of shares issued, was 10% for many years, with an arrangement by which fluctuations in a reserve fund (in fact, an accumulated surplus account) beyond a certain amount were accompanied by a fall or rise in the rates charged by the company. In 1940, the dividend rate was reduced to 8%, the reserve fund having been drawn on for a number of years to maintain the old rate. An increase in the rates charged by the company would not necessarily result in an increase in the profits.

The Bell Telephone Company is subject, with other telephone companies, to the jurisdiction of the Board of Railway Commissioners. All changes in rates have to be approved by the board before they become effective, and no new issues of securities may be made by the company until the board has approved of the terms of issue and the uses to which the funds are to be put. The company is required to file annual returns in the form prescribed by the board.

(2) *Commission.* The monopoly may be operated under public ownership by a commission, itself subject to state control. The commission may be appointed by the government for a period of years; or each member may be appointed for a period of years so that appointments are staggered; or the commission may consist of nominees of certain interests, probably with a chairman appointed by the government. The degree of autonomy and the freedom from political disturbance of these commissions varies very greatly, but control is usually exercised, directly or indirectly by the government, over prices, surplus accumulation, bond issues, and expansion of capital equipment.[9]

[9] J. Willis (ed.): *Canadian Boards at Work*; T. H. O'Brien: *Public Ownership and Control*; W. A. Robson: *Public Enterprise*; A. Brady: *Electric Power in*

The Toronto Transportation Commission was incorporated by the Ontario Legislature on petition of the city. Three commissioners are appointed by the city council, to serve for a three-year period; the council also determines the salaries of the commissioners. The board has almost complete freedom during a period of office, but if it needs funds it must ask the council for them; the council, if it approves, issues debenture on behalf of the commission. The board has power to construct street car lines and to operate street cars and busses, and to construct and operate any other form of transportation entrusted to it by the council. An amendment of the act allowed it to purchase the stock of the Gray Coach Lines. The board fixes the fares "so that the revenue shall be sufficient to make all transportation facilities self-sustaining, after providing for such maintenance, renewals, depreciation and debt charges" as the board thinks proper, and submits an annual report and audited financial statements to the council. No new debt has been incurred since 1924; after providing not only for depreciation and debenture interest, but also for the redemption of debentures out of profits apparently to the amount of thirty million dollars, the accumulated surplus is yet four million dollars, and the board has outside investments worth sixteen million dollars.

(3) *Department of Government.* The direct administration of public utilities by a department of government is very common amongst municipalities in England, but is found in Canada chiefly in the distribution of water and in the postal service. The postal service is unusual in that any change in rates cannot but be a large percentage change; instead of changing rates, the service may be changed or a change take place in the profit or loss absorbed by the gov-

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Report of Royal Commission on Provincial Development and Rehabilitation, Nova Scotia, 1944; *Canadian Journal of Econs. and Pol. Sc.,* August 1936; Articles by A. Brady and J. W. Dafoe; E. Davis: *National Enterprise.*

ernment. This form of control is more direct than the first two discussed, and brings up immediately the question whether a government trading department should operate at a profit and relieve rates, at a loss, increasing rates, or as near to cost as possible.[10]

At cost means that the total cost should be covered by the rates charged; not that each consumer should be charged the cost of the service he receives. A householder should not pay more for his gas or water because he lives far from the gas works or water reservoir. The question whether fares on public vehicles in a municipality should vary with the distance or be the same for all depends on the relative cost of using the two methods and on public policy as to housing.

In a jurisdiction where the permanent officials are well established under a system of proper appointment, only the titular head and his committee (in a municipality, or under-secretaries in the central government) are political appointments, but in a less mature jurisdiction political appointments may be made to all the positions in the department.

Control of Combines

Combination may result in a reduction in social costs or it may result only in a benefit to the units in the combine; it frequently results in the concentration within a small group of considerable economic power. The control of combines is directed to ensure that, whether or not any social benefit results from a particular combine, the combine shall not use its power to the social detriment. Section 498 of the Criminal Code makes it an offence unduly to limit facilities for manufacturing or distributing goods, enhance prices or lessen competition. The interpretation of "unduly" is left for the court to decide in each particular case, and is not likely to go much further in controlling combines than

[10] G. B. Shaw: *The Commonsense of Municipal Trading*. The whole book is pertinent to the subject under discussion.

the common law against unreasonable restraint of trade;[11] little use has been made of this section of the Criminal Code.

The Combines Investigation Act[12] provides for the investigation of alleged or suspected illegal combines by the commissioner, or a deputy commissioner, under the act, or by a special commissioner appointed for the purpose. Action can be taken on complaint or on direction by the Minister of Justice; as a result of the amendment of the act in 1946, the commissioner may himself institute proceedings "Whenever he has reason to believe that a combine exists or is being formed", thus bringing the commission more in line with the Federal Trade Commission in the United States. The report of the commissioner is presented to the minister and is made public unless to do this would be contrary to the public interest. If the report finds that an illegal combine exists, the relevant documents are sent to the Attorney-General of the province in which the offence has taken place.

If the Attorney-General of the province prosecutes, as he normally does, the whole of the proceedings are repeated in a court of law; the Federal Trade Commission in the United States has power to issue orders to "cease and desist", and its findings as to facts are conclusive. If the provincial Attorney-General takes no action, the Dominion can do so; this may result from the offences being committed in more than one province.

Although the commissioner has power to compel the production of evidence, he has no power to convict; although the act provides that, as a result of the report of the commissioner and without judicial proceedings in the Court, the Governor-in-Council may cancel the customs tariff on any goods which are the subject of an alleged illegal combine.

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[11] See L. G. Reynolds: *The Control of Competition in Canada*, p. 134.

[12] See the act itself, L. G. Reynolds: *The Control of Competition in Canada*, and V. W. Bladen: *Introduction to Political Economy*, Ch. VII. The act was amended in some important particulars in 1946.

The reports published, and the annual reports of the commissioner in the *Canada Year Book,* show that very interesting and useful work has been done under the act although it has not been spectacular; in addition, the commissioner has been of great service in giving advice in advance, which may have prevented many from falling into error. In the absence of such a service, uncertainty as to the interpretation of the act which may be made in a particular case might appear to create a hardship. The judgments of the courts against combines up to date have, however, been such as any intelligent reader of the legislation might have expected. The act provides for penalities not exceeding ten thousand dollars or two years imprisonment for an individual, and not exceeding twenty-five thousand dollars for a corporation, but no officer of a corporation charged has been subjected to a penalty as being one "who is a party or privy to or knowingly assists in the formation or operation" of an illegal combine. The effectiveness of the legislation depends partly on the budget appropriation for the work to be done, and it has never been generous.

International Cartels

The word "cartel" was used in Germany usually to indicate a combine which controlled prices and sales, but some international combines have been much more than that. Ivar Kreuger, by means of Kreuger and Toll and the Swedish Match Co., built up an empire of great financial and political power; the armament firms were not so closely integrated, but exercised great power.[13] The activities of international combines may have a profound effect on the economy of particular countries,[14] but are outside the scope of this work.

[13] See P. Noel-Baker: *The Private Manufacture of Armaments*; and A. Plummer: *International Combines in Modern Industry.*

[14] *Canada and International Cartels*: a report by the Commissioner under the Combines Investigation Act; C. R. Whittlesey: *National Interest and International Cartels*; E. Hexner: *International Cartels.*

Unfair Practices

Competition may be reduced and the position of combines made stronger by a vast number of practices which are regarded by some as unfair.[15] Some of these practices (such as bribery of the agent of another) are indictable under the Criminal Code; many others (such as price discrimination for goods alike in kind and quantity), might be punished under the Combines Investigation Act, but that many such practices go on unchecked in Canada, when they would be stopped in the United States by a "cease and desist" order of the Federal Trade Commission, can hardly be doubted. One of the greatest difficulties encountered results from the secrecy in which such activities take place; another from the fear of the small in dealing with the large. If the chief weapon used in Canada for the defence of the general public against combines is the maintenance of competition, unfair practices probably require more attention than they have received.

[15] J. P. Miller: *Unfair Competition* contains a full account of them. See also Report of the Royal Commission on Price Spreads, Chapters VII and VIII.

CHAPTER XI

Reorganization and Liquidation

JURISDICTION

This chapter is concerned mostly with reorganizations of the financial structure of companies, compromises, arrangements and receivership, caused by difficulties in meeting obligations as they fall due; and with liquidation. Other types of reorganization have been dealt with in Chapter V.

Insolvency is under the jurisdiction of the Dominion, and the Bankruptcy Act, which applies to companies as well as to individuals, is a Dominion act. The Companies' Creditors Arrangement Act, passed by the Dominion, has been held to deal with insolvency, and a provincial company can therefore take advantage of it. Provincial companies can be liquidated under the provincial acts provided insolvency is not revealed; the liquidation of insolvent companies, whether provincial or Dominion, comes under the Dominion Winding-Up Act or the Bankruptcy Act. The provincial Winding-Up Acts are shareholders', not creditors' acts.[1] What benefit results from insolvent companies being subject to the Bankruptcy Act and the Winding-Up Act is not clear; proceedings started under the former may be superseded by proceedings under the latter, which seems to be the more appropriate act, after amendment.[2] The Bankruptcy Act contains a great deal which can never be applied to companies.

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[1] The Canadian Abridgment, Vol. 9, p. 946.

[2] See L. Duncan & W. J. Reilley: *Bankruptcy in Canada*, p. 817, on deficiencies in the Winding-Up Act.

Reasons for Reorganization

The inability of a company to meet its liabilities does not necessarily lead to a reorganization of its financial structure. If a company's liabilities are due entirely to unsecured creditors, a reorganization is improbable. The creditors may apply for bankruptcy or winding-up of the company, or the company may make a proposal to the creditors to effect a compromise or arrangement; an arrangement might be made for the creditors to accept shares in settlement of a proportion of their claims, which would lead to a reorganization. Ordinary secured creditors have to decide whether they will fare better by seizing their security, or by agreeing to some arrangement. The seizure of the security may put the company out of business, and the security may not cover the amount of the debt.

Bondholders are a class of creditors apart. Bonds may be secured by a mortgage of specific assets, by a general charge over the floating assets, by the right to appoint a receiver, or, most commonly, by a combination of these. The trustee for the bondholders may have to take action to protect the security if the company is in financial difficulties, even if it has met all the payments required by the trust deed. In some circumstances the bondholders may fare better by exercising their powers under the trust deed; in other circumstances they may fare better by agreeing to an arrangement which involves a reorganization: a change in the relations between bonds and shares, and including, perhaps, other creditors.[3] Although the bondholders may have power under the trust deed to seize and dispose of the assets of the company, this may sometimes be most inequitable to other creditors and to shareholders. The company's difficulties may be temporary but severe, and the market for its

[3] "The bondholders nearly always want to keep the business alive as a going concern for this is their best chance of getting their money out of it."—G. E. Curtis in the *University of Toronto Law Journal*, Vol. IV, p. 145.

assets may be so narrow as to make it possible for a small group (perhaps representing the bondholders) to buy the assets at an absurdly low price in a forced sale of this type. The Court may refuse to allow a sale to take place; reorganization may be arranged or the bondholders may appoint a receiver to manage the company until their claims are met or until a reorganization is effected.

Method of Reorganizing

A scheme for reorganization may be prepared by the management of the company and be submitted by them to bondholders and shareholders. In some companies, the directors of the company may have changed shortly before financial difficulties become acute, for the by-laws of some companies confer on preference shareholders the power to elect all or a proportion of the directors when preference dividends remain unpaid for a certain length of time. When a company is faced by grave financial difficulty, each class of creditor and each class of shareholder has interests in some way opposed to the others, and "protective committees" are frequently organized to represent the interest of these various groups. These committees may oppose or suggest modifications in any reorganization proposed, or they may meet together and bring forward a scheme for reorganization which each committee is prepared to recommend to the group it represents.[4] The Ontario government appointed a committee to prepare a scheme for Abitibi Power and Paper Company after a long period of fruitless negotiations between the parties chiefly interested, who had been represented by six committees.[5]

Protective Committees

Those who organize and form the membership of pro-

[4] See Appendix G. for example of reorganization.

[5] Bondholders, two classes of preference shareholders, common shareholders, general creditors, and an independent committee.

tective committees are often themselves directly, and perhaps heavily, involved in the fortunes of the company. Not infrequently, financial houses which have sponsored the issue of the company's bonds or shares will take a leading part in organizing committees; they have sufficient confidence to expect investors, who have taken their advice in buying these securities, to trust them to salvage as much as possible from the wreckage.

The shareholders of any one class will receive notification that a group has constituted itself a protective committee, and will be invited to authorize the committee to represent them. The authorization that is usually sought is the surrender of the shares and their voting rights in return for deposit certificates; sometimes the surrender is for a fixed period of time and revocable at will by the shareholder; sometimes the surrender is irrevocable and lasts until a reorganization or agreement is effected. Although a committee naturally wishes to have power to make binding arrangements without constantly referring back to the shareholders, the unconditional and irrevocable surrender of voting rights is an extreme measure, particularly if the negotiations are protracted.

Ordinary creditors are organized by one or two who are creditors for large sums; a protective committee is found usually only in connection with a very large company. Secured creditors, other than bondholders, usually consist of banks, and if the bank loan is large, the bank will be brought into the negotiations. Bondholders can appoint a committee, and may also give it power to bind them, if this is provided for in the trust deed; this is now a common provision in trust deeds.[6] In the absence of such a provision, a committee may set itself up and communicate with bondholders, but cannot bind them to a reorganization unless the committee acquires official status under the Companies'

[6] Masten and Fraser: *Company Law of Canada*, p. 439.

Creditors Arrangement Act, which will be discussed later.

Protective committees cannot operate without expense, and those who organize them run some risk in doing so. To collect cash from those they wish to represent is difficult, and the attempt to do so may prevent them from obtaining the majority required to enable them to bind the class for which they are acting. Any arrangement that is eventually arrived at will provide for the payment of expenses and fees for members of the committees which have taken part in the negotiations.

Reorganization under Various Acts

The purpose of a reorganization is to postpone or reduce the immediate burden of liabilities, and to adjust the rights of all classes of creditors and shareholders in such a way that the company has a reasonable likelihood of carrying on successfully, and that all parties are reasonably well satisfied with the plans. A further point, which may be of supreme importance, is the making of arrangements to enable the company to obtain additional funds. The agreement frequently provides that the bondholders shall have the right, for a period of time, to appoint a proportion of the directors; the same right may also be conferred on holders of preference shares. The company may also be restricted in its power to declare dividends so as to conserve liquid funds for the further protection of bondholders.[7] A reorganization may be proposed before the company is in extreme difficulties, or after proceedings have been taken by bondholders under the terms of the trust deeds, or by ordinary creditors under the Bankruptcy or Winding-Up Acts.

(*a*) *Under the Companies Act.* The shareholders have the power, by special resolution and subject to the consent

[7] E.g. Maple Leaf Milling Co. No dividends may be paid until bonds outstanding have been reduced to $3,000,000. and unless working capital is maintained at not less than $2,000,000.

of a judge, to agree to a reorganization which binds all of them. The bondholders have the power to agree to a reorganization only if so provided in the trust deed. The trust deed nowadays usually empowers them to set up a committee, and to confer on that committee the right to negotiate for and to bind all the bondholders. If the proposals accepted do not involve the acceptance of shares by the bondholders in payment of arrears of interest or in reduction of their interest rate, the share capital may remain without change; but as arrears of preference dividends have probably been built up, the opportunity is usually seized of dealing with the whole financial structure at one time.

The Canadian Locomotive Company failed to meet its bond interest payment in July 1932, and a reorganization was agreed to and sanctioned very promptly. Each old 6% Bond was exchanged for a new 6% Income Bond (interest and sinking fund paid only when earned, but cumulative), and two new Common Shares; the defaulted interest was eliminated and no interest was to be paid on the new bonds for the first two years. The bondholders nominated three people to hold management shares which carried the right to appoint the directors for the first five years. The holders of the 7% Preference Shares received in exchange an equivalent number of new Common Shares, and some three years' arrears of cumulative dividends were cancelled. The common shareholders received one new for each five old shares.

(*b*) *Under Companies' Creditors Arrangement Act.* When the trust deed for a bond issue does not provide for the modification of its terms with the consent of the bondholders, a proposal can be placed before the bondholders by calling a meeting under this act and by direction of the Court. The meeting may be called on the application of the company, a creditor, the trustee in bankruptcy or the liquidator, and proceedings in bankruptcy or winding-up may be

stayed. The required majority of bondholders or of creditors of any other class binds the whole of the class. Although the act provides that meetings of shareholders may also be called by direction of the Court, it does not give much indication as to what purpose is served. If a reorganization is proposed which will deal simultaneously with bondholders and shareholders, action must also be taken under the Companies Act.[8] The Companies' Creditors Arrangement Act appears not to be a very satisfactory piece of legislation.[9]

(*c*) *Under the Bankruptcy Act.* As stated above, a proposal under the Companies' Creditors Arrangement Act may result in proceedings being transferred to its jurisdiction from the Bankruptcy Act. The latter act, however, provides for reorganization after a company has been declared bankrupt, and also for the bringing in of new capital by an issue of shares to creditors or shareholders. If the scheme is approved by the required majorities of both creditors and shareholders, dissentients may withdraw if they are called upon to subscribe to a new issue, and receive compensation for their interest.[10]

(*d*) *Winding-Up Act.* A reorganization may be proposed and submitted to meetings of each class of creditors. If it is approved by the requisite majority and sanctioned by the Court, the scheme, in so far as it affects shareholders, must also be submitted to the shareholders as provided for in Section 123 of the Companies Act.

Fractional Certificates

In a reorganization involving the surrender of shares and the substitution for them of a different number of shares, difficulties arise because a share cannot be subdivided.

[8] Section 19 of the Companies' Creditors Arrangement Act, and Section 123 of the Companies Act.

[9] See L. Duncan and W. J. Reilley: *Bankruptcy in Canada,* pp. 1108, 1114, and 1121.

[10] See L. Duncan and W. J. Reilley: *Bankruptcy in Canada,* p. 189.

If a reorganization provides that each shareholder is to receive one share for every two held, what is to happen to a holder of three shares? The best way of overcoming this difficulty is to provide in the scheme of reorganization presented to the shareholders that a certain number of the new shares are to be held by a trustee on behalf of all those entitled to a fractional interest in a share. The trustee issues fractional certificates, which can be traded in much the same way as can shares, and these are gradually consolidated into whole shares as a result of trading; the trustee releasing a share to anyone who surrenders the proper number of fractional certificates. The arrangement may provide for compulsory consolidation of certificates, at a price bearing some relation to the current market price of the shares, at the expiration of a time limit.

Compromise

In the last section reorganization was considered, particularly as it affects bondholders and shareholders. Such a reorganization involves a compromise, and has been dealt with above, but every compromise does not lead to a reorganization. The chief thing about a compromise is, perhaps, the intention that the company shall carry on its business as a going concern, thus avoiding extinction under threatened or actual bankruptcy or liquidation. To enable the company to do this, some reduction in the burden of its liabilities is necessary. The initiative may be taken by the company before any proceedings in bankruptcy or winding-up have been started; by the receiver in bankruptcy; by the liquidator in winding-up; or by any class of creditors at any time. The company may request the trustee in bankruptcy to call a meeting, or if the company is in the course of being wound-up, the Court may order a meeting of creditors on the application of a creditor or the liquidator. Under the Companies' Creditors Arrangement Act, the company, a

creditor, the trustee in bankruptcy, and the liquidator are all entitled to apply to the Court for a meeting of creditors to consider a compromise.

Unless a company is in a completely hopeless position, the management will probably do their best to effect a compromise, because the company is otherwise likely to cease to exist after bankruptcy or winding-up proceedings. If a company ceases to exist, the management jobs also cease to exist. For an individual, bankruptcy may be a better alternative than a composition with his creditors, allowing him to make a new start entirely free of debt, and, if he has been honest, without any handicap.

Whether the meeting of creditors is held under the Bankruptcy Act, the Winding-Up Act or the Companies' Creditors Arrangement Act, the compromise becomes binding only after it has been passed by the required majority of each class of creditors affected, and has been sanctioned by the Court after hearing objections of any dissident creditors.[11]

Procedure on Insolvency

The details of legal procedure are not recorded here; nor are the rights and duties of trustees in bankruptcy and liquidators. This book is concerned mainly with the organization, financing, and management of companies; what happens when the company ceases to exercise control over its assets, in bankruptcy or winding-up, is outside the scope of the book. However, the legislation appears to be hopelessly and needlessly confused.

When a company is approaching insolvency, it may bring forward a scheme for reorganization and compromise. This action, or the failure of the company to meet its liabilities, or adverse credit reports, may give creditors their first warning. The purposes of the Bankruptcy Act and the

[11] Bankruptcy Act, Sections 11-13; Winding-Up Act, Sections 65-6; Companies' Creditors Arrangement Act, Sections 3-5.

Winding-Up Act (as far as insolvency is concerned) are to protect the assets of the company for the benefit of the creditors, and to prevent undue discrimination in the settlement of creditors' claims;[12] and to carry out these purposes control of the assets has to be removed from the directors and management. Creditors may take action under either act; a comparison between the acts would become too involved.[13] The Bankruptcy Act provides for the appointment by the creditors of a committee of inspection which has some control over the trustee; the Winding-Up Act provides that the Court may appoint inspectors whenever it deems it necessary, to assist and advise the liquidator, but the liquidator has to refer many matters to the Court for approval.

Receivership under Trust Deed

Great care is required in drawing up the terms of, and registering the trust deed for a bond issue. Such deeds now usually mortgage the specific assets and give a general charge over the whole business of the company; and provide for the appointment of a receiver and manager by the trustee, with power to carry on the business. If the trust deed gives a mortagage only of specific assets, those assets can be seized and sold under supervision of the Court; if the trust deed does not provide for the appointment of a receiver, application must be made to the Court for such an appointment. On the appointment of a receiver and manager the officers of the company cease to have any powers. The receiver's job is to secure the payment of the bondholders' claims, and he may try to sell the business as a going concern, or dispose of the assets separately, but the Court will not give its approval to any sales which appear inequitable as far as shareholders are concerned.[14] Normally,

[12] As far as individuals are concerned, the Bankruptcy Act has also the very important function of providing a means by which an honest man may escape from an intolerable burden of debt, and make a fresh start.

[13] See L. Duncan and W. J. Reilley: *Bankruptcy in Canada*, p. 817.

[14] See above under "Method of Reorganizing".

the receiver will carry on the business in the hope of a reorganization being proposed which will be acceptable to the bondholders, or of selling the business as a going concern; if his management is successful, a reorganization may be effected which results in no loss to the bondholders. The trust deed should give the trustee power to appoint a receiver for the bondholders immediately an application is made for a receiving order in bankruptcy or for a winding-up order, even if the company has not defaulted in payments to the bondholders. If proceedings in bankruptcy or winding-up have started, the receiver can still seize the security.

The receivership comes to an end, and the company regains control of its assets if a reorganization is approved and sanctioned, but the reorganization may include an arrangement for the bondholders to appoint all or some of the directors for a period of time. If the business is sold, then the receiver hands over to the control of the company any excess cash after the bondholders have been paid in full their capital and interest.

Bankruptcy

A creditor may take action against a company under the Bankruptcy Act. He makes application to the Court and offers proof of his debt and of an "available act of bankruptcy".[15] If the Court is satisfied, it issues a receiving order and appoints a custodian; his duty is to assume control of the assets and conserve them, and to call a meeting of creditors at which a trustee is appointed to take over from the custodian. The company loses all control over the business and the trustee sets to work to realize the assets in cash (either by sale of the business as a going concern or by sale of the assets singly), under the advice and control of a

[15] The acts of bankruptcy most likely to be committed by a company are: permitting execution under which goods are seized, to remain unsatisfied; exhibiting a statement disclosing insolvency at a meeting of creditors; ceasing to meet liabilities generally as they become due.

committee of inspectors. If the trustee does not obtain sufficient funds from realization of the assets to meet the liabilities, he can collect from the shareholders any amounts remaining unpaid on their shares. In Canada, this is a matter of little importance, for almost all shares are fully paid from the time they are issued. Share transfers may be made even after the receiving order, but not for the purpose of escaping liability.

A proposal for a compromise or arrangement with the creditors may be made by the company; this will be presented by the trustee to the committee of inspectors and, if authorized by them, he will call a meeting of creditors to consider the proposal. Before a scheme is put into operation, it must be accepted by the required majority of creditors, and approved by the Court after hearing the views of dissident creditors and the trustee. Upon the approval of a scheme of arrangement, the trustee hands back control of its affairs to the company. In the absence of a proposal by the company, the trustee proceeds with the realization of the assets and the proof of creditors' claims. In the improbable event that any balance remains when all claims are settled, he hands this back to the officers of the company. The Bankruptcy Act does not apply to building societies having capital stock, incorporated banks, savings banks, insurance companies, trust companies, loan companies or railway companies.

Companies' Creditors Arrangement Act

Reference has already been made to this act under the heading Reorganization under Various Acts. The act can be invoked before any proceedings have been taken under the Bankruptcy or Winding-Up Acts, or after a receiving or winding-up order has been made by the Court. The creditors have, presumably, the choice as to which act shall be used; the regulations under the Bankruptcy Act are more

stringent than those under the Companies' Creditors Arrangement Act. The wording of the definition of company or corporation, and therefore of the companies exempt from the act, varies from one act to the other.

Liquidation when Insolvent

When a company is insolvent (as defined in Section 3 of the Winding-Up Act) it may apply to the Court for a winding-up order; application can also be made by a creditor for the sum of at least $200 or by the holder of a certain minimum number of shares. If an application has already been made and a receiving order issued under the Bankruptcy Act, application may be made for leave to apply the provisions of the Winding-Up Act to the proceedings. When the Court issues a winding-up order, it also appoints a liquidator, who takes over the assets of the company. The business of the company ceases except when the liquidator thinks it beneficial for the winding-up to continue the business, for which the approval of the Court is necessary. No transfers of shares can be made after the winding-up order except with the consent of the liquidator under authority of the Court.

The functions of the liquidator are to realize the assets, to establish a list of creditors and their claims, and to prepare a list of contributories: that is, of shareholders, showing separately the amounts unpaid on shares held by them, and any past shareholders against whom claims can be established. In the liquidation of a bank, this includes the remaining double liability provided for in Section 125 of the Bank Act. On the application of a creditor or a shareholder the Court may (but is not obliged to) stay proceedings; one of the grounds for such an application is that a proposal has been made for a compromise with the creditors. If, when the liquidator has realized the assets and paid the creditors, a balance of cash remains, this balance is distributed

by the Court amongst the shareholders in accordance with the charter of the company; the liquidator is discharged, and the company ceases to exist. The Winding-Up Act has a wider application than the Bankruptcy Act, but does not apply to building companies not having a capital stock, railway or telegraph companies.

Liquidation and Dissolution when not Insolvent

Unless evidence of insolvency is presented, the Dominion Winding-Up Act applies only to companies which have obtained their charters under Dominion legislation; provincial companies are liquidated under provincial acts. The voluntary liquidation of a solvent company is not a frequent occurrence. On the application of the company or a shareholder, a liquidator is appointed by the Court, and he proceeds to realize the assets and discharge the debts, and establish a list of contributories amongst whom the balance is distributed by the Court in accordance with the charter of the company.

Under Section 29 of the Companies Act, a company may surrender its charter and be dissolved without the intervention of the Winding-Up Act, on the grounds that it has no assets, these having been distributed to the shareholders, and no liabilities. A company which, as a result of a resolution of the shareholders, has sold its business to another company, is likely to seek dissolution under this section of the act.

CHAPTER XII

Summing Up

Origin of Corporations

An unfortunate difference in terminology between North America and the United Kingdom leads to some slight confusion. In North America the word corporation is used most frequently to denote a limited company; it is used also in a wider sense to include any organization operating as a unit but not a sole proprietorship or a partnership. In the United Kingdom, the word corporation is used most frequently to denote a municipality; a wider use, which includes business organizations in which the public has a direct interest, is common; the widest use in the United Kingdom coincides with that in North America. The corporation, in this wide sense, was known to Roman Law; indeed, Blackstone stated that the honour of inventing corporations "entirely belongs to the Romans . . . our laws have considerably refined and improved upon the invention, according to the usual genius of the English nation".[1] Perhaps it would be fairer to say that the genius of the English was capable of evolving so necessary an institution as a corporation; that it is to be found in guilds and religious and civic organizations indigenous to England. "Corporate bodies existed and were recognized before a theory was invented to explain their existence and recognition".[2] That Canadian corporations derive, in the main, from English is not in doubt.

[1] Quoted in F. W. Maitland: *Collected Papers*, Vol. III, p. 212.

[2] W. M. Geldart: "Legal Personality", in *The Law Quarterly Review*, Vol. 27, p. 96.

Corporate Personality

A great deal has been written about the attributes of a corporation without arriving at any final conclusion, partly because of the anthropomorphic approach. Coke formulated the doctrine that the corporation was a fictitious person created by the state, and that this person lacked certain of the attributes of a natural person.[3] It is a doctrine with an immediate appeal, which has found favour in the courts for three hundred years; the courts have added, with some uncertainty, attributes denied by Coke, for the corporation now includes organizations not dreamed of by him, and "the formal character of legal phenomena cannot be studied apart from their social contents."[4] The Courts have held that corporations can now be actuated by malice.

Formal incorporation is the prerogative of the state, but many organizations act as corporations without formality: e.g., trade unions and clubs. "A man thinks of his club as a living being, honourable as well as honest, while the joint-stock company is only a sort of machine into which he puts money and out of which he draws dividends."[5] For the purposes of corporation finance, the importance of corporate personality is twofold:

(1) First is the relationship between the corporation and the state (which may itself be thought to be a corporation), the shareholders, and the management. As limited companies can be brought into being only as provided by Act of Parliament, they are subject to regulations which do not apply to natural persons. The corporate will is determined, theoretically, by the shareholders acting within those regulations, but the majority does not always and necessarily carry the day. The company cannot act except through natural persons: the management; but although the man-

[3] F. Hallis: *Corporate Personality*, p. xiii.
[4] *Ibid.*, p. 240.
[5] Maitland: *Collected Papers*, Vol. III, p. 383.

agement act in a way similar to that of an agent, they are not agents, for they are part of the corporate personality—its brains, perhaps, but they can be dismissed and others appointed in their place. The management can bind the company only when acting within the powers of the company, yet in doing so, they can cause the company to act with malice. The analogy with a natural person begins to wear a little thin.

(2) Secondly, the idea of a company being a person entirely separate from the shareholders and management has tended towards cold and irresponsible management; the concept of corporate personality has resulted in impersonal management. "The modern corporation . . . does not represent the natural growth of the corporate idea, but rather as a distorted application of that idea. Serving as a buffer between questionable acts and their natural consequences, it has been used to bring about a state of affairs in the commercial world which rests on neither a just nor a sound basis."[6]

Origin of Limited Company

In England, the joint-stock company was the result of a gradual evolution which adapted commercial institutions to their expanding opportunities; in the background are guilds, partnerships and joint ventures abroad. The increase in foreign trade led to the granting of charters to "regulated companies", which served much the same function as did the guilds in domestic trade, and which were granted monopolies for trade in particular areas. The regulated companies did not, however, trade as companies; they were, rather, regulating companies, whose members traded on their own account. Within these regulated companies, members started joint-stock ventures for specific periods or purposes;

[6] R. L. Raymond: "The Genesis of the Corporation" (Harvard Law Review, Vol. 19, p. 364).

and because of the type of business carried on, the chances of liability to loss, apart from the amount subscribed for the venture, were negligible. The Russian Company was granted a charter in 1553, and was the first true joint-stock company in that the members were expressly excluded from entering this trade on their own account.[7] Joint-stock companies were incorporated by Royal Charter for other foreign ventures: e.g., The Hudson's Bay Company, The East India Company, and the strange New Scotland Company, active participation in which carried with it a Nova Scotia baronetcy.[8] These companies had limited liability.

The need to draw capital from more sources than could be tapped by a manageable partnership, the willingness of members of the general public to subscribe funds, the opportunity for unscrupulous promoters to direct those funds into their own pockets, and the existence of brokers who dealt in government bonds and in the shares of properly incorporated companies, but who were willing to expand their business, led to the setting up of businesses which pretended to be companies. At this point limited liability was not important (it was attained by some "companies" which made it a condition of all contracts into which they entered); the chief concern was that shares should be issued and be transferable. The granting of charters by statutory authority for domestic purposes (The Bank of England and the London Assurance) had encouraged the movement.[9] The bursting of the South Sea Bubble in 1720, and the breaking of the speculative boom in shares of many companies, brought a violent reaction and stringent legislation. Each improvement in business resulted in a movement to widen the scope

[7] M. Schmitthoff: "The origin of the Joint-Stock Company", (*University of Toronto Law Journal*, Vol. 3, p. 91).

[8] W. R. Scott: *The Constitution and Finance of English, Scottish* and *Irish Joint-Stock Companies to 1720*, Vol. II, p. 319.

[9] B. C. Hunt: *The Development of the Business Corporation in England 1800-1867*, p. 5.

of business for which a charter might be granted, and in the promotion of companies which lacked formal incorporation; each depression saw the exposure of malpractice and a tightening of the law. Each request to Parliament for a charter was supported by arguments which were based on the economic changes that were taking place, and opposed by sturdy individualists who had many examples from history on their side. "Those who resist improvements as innovations will soon have to accept innovations that are not improvements."[10] By the acts of 1856 and 1862, incorporation with limited liability, for almost any purpose and with a minimum of regulation, became possible. This was the lowest point in English company law; but North America did not reach its lowest point until, perhaps, 1930, and the state of Delaware, in particular, had by then incorporated indescribable monstrosities.

The End of a Period

Unfortunately, Adam Smith wrote at the end of an economic period, and the shadow of the coming changes was not deep enough for him to see it; otherwise his condemnation of companies would not have been so severe.[11] The East India Company was successful "during a momentary fit of good conduct"; the Hudson's Bay Company was moderately successful because of its monopoly and its small number of members. "The only trades which it seems possible for a joint stock company to carry on successfully, without an exclusive privilege, are those, of which all the operations are capable of being reduced to what is called a routine, or to such a uniformity of method as admits of little or no variation." (Banking, fire and marine insurance, canals and water works!) "The joint stock companies which are established for the public-spirited purpose of promoting

[10] Canning, quoted by Lord David Cecil: *The Young Melbourne*, p. 133.
[11] *The Wealth of Nations*, Book V, Ch. I, Part III, Article I.

some particular manufacture, over and above managing their own affairs ill, to the dimunition of the general stock of society, can in other respects scarce ever fail to do more harm than good."

By the time John Stuart Mill wrote[12] a considerable change had taken place, but the above was no worse than "one of those overstatements of a true principle, often met with in Adam Smith". Yet he modifies the judgment not only by stating that banking, insurance, railways, and shipping should be run by companies, but also by seeing that "where the concern is large, and can afford a remuneration sufficient to attract a class of candidates superior to the common average, it is possible to select for the general management . . . persons of a degree of acquirement and cultivated intelligence which more than compensate for their inferior interest in the result"; and "In the case of managers of joint stock companies, and of the superintending and controlling officers in many private establishments, it is a common enough practice to connect their pecuniary interest with the interest of their employers, by giving them part of their remuneration in the form of a percentage on the profits."

The necessity for a change in manufacturing and trading institutions came as a result of mechanical inventions. These inventions brought about a revolution in transportation; the two together made possible operations on a scale much larger than had previously been possible. Watt's great invention was put to use barely twelve years before the publication of *The Wealth of Nations* in 1776; Stephenson's invention came in 1814, and Mill's work was published in 1848.

Significance of the Company

The importance of the limited company in contemporary life need not be laboured; in spite of the large number of

[12] *Principles of Political Economy*, Book I, Ch. IX, Section 2.

sole proprietors and partners engaged in manufacturing and in retail selling, the volume of business conducted by companies is far greater. Agriculture and the professions are the remaining preserves of individual enterprise. The company dominates the national economy.

Although the issuing and transference of shares and the use of a corporate name marked a distinct advance, the advance was a natural one; the general introduction of limited liability in business relations was revolutionary, and although at long last achieved, was condemned as the most violent interference with private enterprise,[18] sometimes in words very similar to those now used in condemnation of public enterprise. "Was not Britain's unexampled prosperity due to 'the competition of individual exertions'?" "A corporate body could not possibly serve the public with gas light to more advantage than individuals . . . James Watt thought that competition would be destroyed. He even declared: 'I should get out of business as soon as possible,' if such a body were to be set up." "*The Times* remarked a few years later: 'Nothing can be so unjust as for a few persons abounding in wealth, to offer a portion of their excess for the formation of a company, to play with that excess—to lend the importance of their whole name and credit to the society, and then should the funds prove insufficient to answer all demands, to retire into the security of their unhazarded fortune, and leave the bait to be devoured by the poor deceived fish.' " "He (Huskisson) was especially opposed (at this time) to the limitation of liability, 'to taking every wild and idle speculation out of the general operation of the laws of the country.' " "Debate on the bill to incorporate the West India Company evidenced prejudice against any company *qua* company. As one member inquired impatiently, 'how could a company possibly carry on the

[18] The following quotations are from Hunt: *The Development of the Business Corporation in England,* pp. 24, 26, 29, 33, 34, 55, and 69.

business of plantations better than individuals?' . . . if this bill were carried 'there was no reason why joint-stock companies of butchers and bakers should not be established'. Deeper fears agitated others—Lords Redesdale and Westmorland were apprehensive lest the creation of so many companies prove dangerous to the Constitution". "The *Monthly Review* wrote: 'the age of companies is past . . . the proper occasions for such associations are comparatively rare and the principle degenerates into a pestilential abuse when it is applied to an ignorant and impertinent interference with the smaller details of trade, endeavouring to crush the humbler industry of individuals by the overwhelming power of capital *alone*'." "McCulloch excoriated Clay's proposal. 'The adoption of limited responsibility would be productive of the most injurious results and would go far to annihilate whatever there is of solidity in the present system.' It would involve 'the abolition of a law under which the manufactures and commerce of the country have grown up to their present unexampled state of prosperity . . .' "

The development of limited companies involved another revolutionary change of even greater significance; the divorce of management from ownership. The change, which introduced an entirely new relationship into the conduct of industry and trade, has only recently received the attention it deserves. Limited liability profoundly altered the risks of business; the divorce of management from ownership transferred part of the decision on risk-taking from the owners. Further, it brought into play the interests of the management, which might not coincide with those of the company or of the almost inarticulate shareholders. Although many economists have described the company, and have referred to its influence in facilitating the growth of large-scale enterprise and combination, none appears to have taken any notice of these two fundamental changes in his theoretical analysis; corporate personality has been swallowed whole. But a man

does not shed his prejudices, passions and personal motives when he acts as a manager, yet retain them when he acts as a consumer.

Control of Companies

In the days of individual enterprise, control of business was at a minimum. No sole proprietor or partnership was of sufficient size to affect the public welfare materially under a system of almost completely free competition, yet each business man was accountable for his acts. When a business reaches a certain size, and its actions become significant, control by the state is essential to preserve the freedom of others. The City of Sherbrooke sent the following telegram to the Prime Minister early in 1936: "Special emergency meeting City Council held today strongly ask that your Government intervene immediately over the situation that has developed whereby our largest flat silk industries employing over a thousand hands has suddenly closed down leaving these people without employment. Our City unable to cope with alarming situation and request your Government take immediate steps to remedy this condition. City cannot take care of such increased unemployment."[14] "I think that the circumstances surrounding the closing of the Sherbrooke mill, as they were made to appear, by the company, to the Government, to the public and to the company's employees, indicate hasty action, taken without due consideration, causing, as it was bound to cause, distress and alarm . . ."[15]

Apart from this general justification of control some control of limited companies is justified by the privileges they enjoy: those of limited liability and the drawing of capital from many sources by the issue and transfer of shares. Whatever may be thought of corporate personality,

[14] Report of the Royal Commission on the Textile Industry, p. 5.
[15] Report of the Commission, *ibid.*, p. 28.

the modern limited company derives its privileges from Act of Parliament, and is properly subject to regulations which protect the creditor from the company and the shareholders from the directors. The controls exercised over companies through the Companies Act, the Securities Acts and the Combines Investigation Act have already been considered. In Canada, two other forms of control are worthy of mention. The published accounts of companies (not, unfortunately, extending to private companies, some of which occupy a very important place in the economy of the country: e.g., Eaton's and General Motors) are subject to private scrutiny, but not to the close and critical analysis to be found in the English financial papers; and, when public opinion is aroused, a Royal Commission is appointed to enquire and report: e.g., Beauharnois, Price Spreads, Textile Industry. The Royal Commission usually discloses a state of affairs which could not have arisen had effective control been exercised.

Present Position of Companies

As companies become larger their system of management approximates more and more to that of the great public enterprises run by commissions, except that the managers are freer of ultimate control by government.[16] "The salaried business leader receives a generous income and to the size of the reward are added the attraction of security and stability."[17] The employees, particularly those at the lower management level, become more and more like civil servants, but with less security. Bureaucracy, which despite its faults should not be used as a term of abuse, becomes a necessity; it brings with it administrative difficulties which are inherent in successful large-scale operation. A willing belief in corporate personality leads to assumptions that are

[16] See Temporary National Economic Committee, Monograph No. 11: *Bureaucracy and Trusteeship in Large Corporations.*

[17] R. A. Gordon: *Business Leadership in the Large Corporation*, p. 296.

by no means valid. A company does not take risks nor can it display initiative, although it may lose or gain as a result of the risks taken or the initiative shown on its behalf by the management.

Nor is the management a personality; it may consist of several hundreds of employees in a large company. The chief executive officers find their time more and more occupied with co-ordination and the making of final decisions. Initiative is likely to be found elsewhere, and it may sometimes be impossible to trace the origin of a new idea.[18] ". . . the traditional reward of the business leader—the profit from business ownership—is not a primary incentive to the majority of top executives in our largest corporations."[19] That initiative is not shown by those who may not reap personal reward from it is no more true of large companies than of public enterprise.[20] The Toronto Transportation Commission has recently startled the sober business men of the city by plans for vast expansion. In any case, it is a stupid thing to say to a university professor.

The incentive of large personal profits has played an important part in the affairs of large companies, but usually in a way which has brought discredit to those concerned and obloquy to the limited company as an institution. The many abuses brought to light show that the controls that existed were not adequate, and we do not know whether they are now adequate to prevent the practice of new and ingenious methods of fleecing the public when the opportunity arrives. Whether justly or not, the severity of the depression is attributed by many people to the inadequacy of big business. "The workman's grievance is that he, too, has to pay the piper, though he never had the fun of calling the tune, and, indeed, had he had the chance, would have called, or thinks

[18] *Ibid.*, Chapters IV and V.

[19] *Ibid.*, p. 312.

[20] See Sidney and Beatrice Webb: *Soviet Communism*, p. 794. "Soviet Communism has proved to be, in all fields, almost wildly initiating."

he would have called, a very different one. He may be too ignorant to understand the causes of 'bad times' of which he is the victim. But he is apt to suspect, and, as we have seen, with some reason, that they are not due to inexorable Fate, but in great part at least to human blundering, not to say human dishonesty. And that blunders . . . were made by those who had the power, as he has not, of steering the ship of industry, and who ought not, as he thinks, to have steered it on to the rocks."[21] That thirty per cent of the workers in Canada were unemployed for reasons entirely beyond their control causes people to seek to find out where the responsibility lay; if management denies all responsibility for depression, it is not entitled to any pride in achievements in good times. "Too many businessmen are still prone to rely upon slogans rather than study as a basis for their economic judgements. Too many businessmen are still giving voice to the old clichés which passed for wisdom in the unlamented 1920's."[22]

Although the corporate form of business has shown great resilience under repeated blows in the past, its ability to withstand or recover from another blow equal to that delivered by the disclosures and disasters of the early thirties may be doubted. Large companies are one of our most important social institutions, and can justify their continuance only if they serve a social purpose with reasonable efficiency.[23] "Directors appear to be at the crossroads; they need to know their duties and meet them adequately, or drastic changes may well occur which would completely revolutionize the character of the control and supervision of American business and industry."[24]

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[21] Lord Milner: *Questions of the Hour*, p. 77.

[22] P. G. Hoffman: "The Survival of Free Enterprise", in *Harvard Business Review*, Vol. XXV. No. 1, p. 26.

[23] P. F. Drucker: *Concept of the Corporation*, p. 17, and *The Future of Industrial Man*, p. 291.

[24] J. C. Baker: *Directors and their Functions*, p. 10.

The Position of Shareholders

The typical shareholder in a large company is a person who is entitled to participate in any dividend declared by the directors on the class of shares of which he is a holder. Having purchased his shares, the only risk he can run is that of holding on to them; he has no power of initiative. He has the power to vote, but that power is useless to him unless organized by someone else; as an individual he is a nonentity. "As a qualification on what has been known as private property in Anglo-American law, this corporate development represents a far greater approach toward communist modalities than appears anywhere else in our system. It is an odd paradox that a corporate board of directors and a communist committee of commissars should so nearly meet in a common contention. The communist thinks of the community in terms of a state; the corporation director thinks of it in terms of an enterprise; and though this difference between the two may well lead to a radical divergence in results, it still remains true that the corporation director who would subordinate the interests of the individual stockholder to those of the group more nearly resembles the communist in mode of thought than he does the protagonist of private property."[25] The typical shareholder is not engaged in private enterprise; all he has done is to choose an investment. The bonds of some countries and the common shares of some companies offer the prospects of security and low returns; the bonds of other countries, the preference shares of other companies, and the wildest mining shares, offer, at the other end of the security scale, the possibility of large profits or almost total loss. The investor is not normally bothered about private or public enterprise, and

[25] A. A. Berle and G. C. Means: *The Modern Corporation and Private Property*, p. 278. The comparison can be taken further. Drucker: *Concept of the Corporation*, p. 123, draws attention to a remarkable resemblance between the large divisions of General Motors Corporation and the Russian "Trusts".

although the conditions and paper rights attached to bonds and shares vary, the investor buys and sells without being aware of them; or, if he is aware of them, failing to realize that their immediate implications are probably false.

The large shareholder, in any except the largest companies, is much nearer to the conventional idea of a shareholder; his opinion may be respected, even if he is not part of the management group, because he is a potential leader of revolt. In very large companies whose shares are widely held, the management group can with safety ignore any individual shareholder. Financial institutions, particularly insurance companies, hold large blocks of shares in certain companies, and this may result in interlocking directors or unofficial consultations, although financial institutions seldom wish to become involved in the problems of management of other companies.

A discussion of the position of shareholders in large companies must not be taken to suggest that the interests of shareholders are always opposed to those of the company, or that the management of a company spends a large proportion of its time in devising nefarious schemes to the detriment of simple and trusting shareholders. The discussion aims only to show that the traditional understanding of private enterprise in no way describes the average shareholder today.

Functions of Directors

No very clear and generally accepted statement of the functions of directors can be found; directors as a class have probably changed their own conception of their functions very considerably in the past fifteen years. To obtain a true statement from someone as to what he thinks his functions are, is often very difficult; partly because many people do not formulate their ideas, and partly because they tend to say what they think sounds right instead of what is true.

In the past, a good director might have thought his job was to look after the interests of shareholders, although as early as 1929 the chairman of General Electric Company said, "My conception of it is this: that there are three groups of people who have an interest in that institution. One is the group of fifty-odd thousand people who have put their capital in the company, namely, its shareholders. Another is a group of well toward one hundred thousand people who are putting their labor and their lives into the business of the company. The third group is of customers and the general public."[26]

In all discussions about directors, the personalities concerned are of such importance and are so various that generalization is difficult. A chart can be drawn up showing the organization of a company and the relation between the board of directors, the executive officers, the departments, and so on. A list of functions may be appended to it, showing that the directors are responsible for the over-all policy of the company; for the appointment of officers and the determination of their remuneration; for the critical examination of statements prepared for them by the management; for the declaration of dividends; for the issue of bonds and shares. But these mean one thing with one group of personalities and another thing with a different group. Working with the same paper plans, one board may exercise control and initiative, and another board be nothing but a talkative rubber stamp. "Directors have the critical function of asking discerning questions at board meetings."[27] That they also have final responsibility for management and that they are "trustees" now seems to be widely accepted, but to whom they are responsible and for whom they are trustees is not easily decided, legally or morally.[28] "The essential

[26] Quoted in Baker: *Directors and their Functions,* p. 6.

[27] *Ibid.,* p. 13.

[28] *Ibid., passim*; Berle and Means: *The Modern Corporation and Private Property,* Book II, Ch. V; Report of the Royal Commission on the Textile Industry, p. 29,

concern of corporation directors, particularly in our large corporations, is not today, nor should it ever have been, merely protection of stockholders and their interests. These functions are simply more in evidence than others. The problem is vastly more important. It is the reconciliation of private enterprise with the smooth functioning of democratic society with justice to all groups: stockholders, executives, employees, creditors, customers, and the public. Such a broad concept of the functions is frequently overlooked. Nevertheless, this should be the contribution of directors to our national life."[29]

Appointment of Directors

Something has already been said about the appointment of directors in Chapter II, but this now needs to be expanded. Theoretically, the shareholders (except in special circumstances[30]) elect the directors, but in practice the promoters appoint the directors, who become a self-perpetuating body. Whether the directors or the management nominates someone to fill a vacancy on the board depends on the personalities concerned and the traditions established in each company. In some companies, all the directors are active and even full-time, and are completely conversant with the whole business of the company; in other companies, only the chief executive officer and, perhaps, one other director, is in this category. In some large companies, the directors appoint an executive committee to which wide powers are delegated; this committee may also consist exclusively or partly of full-time directors with real knowledge of the business.

Although the number of directorates held by any one person in Canada is now probably much lower than it was ten

and Ch. XI; Report of the Royal Commission on Price Spreads, pp. 39 and 45; Temporary National Economic Committee, Monograph No. 11, Ch. V.

[29] Baker: *Directors and their Functions*, p. 138.

[30] See Chapter XI under "Reorganization Under Various Acts" (a).

years ago, the same names are met frequently in lists of company directors. A certain amount of specialization of interests is found, but some directors are to be found on boards of companies with the most diverse interests. Speaking of men who were directors of a large number of companies, Lord Bennett, when Prime Minister of Canada, said: "They control the companies they head but in the case of others I know they often do not attend the directors' meetings."[31] A remark which is doubly illuminating. While a discussion of what type of board is best suited to particular companies is beyond the scope of this book, it is not irrelevant to say that the appointment of one man to the boards of many diverse companies, or the appointment of passive directors, is undesirable; some companies object to their directors accepting appointments to the boards of other companies.[32]

Failure to re-elect a director, even when his faculties are obviously failing, is not common. Directors resign, of course, and without inside information, no one can tell whether the resignation is due to pressure; death is probably a more frequent cause of vacancies. Some companies have a rule that directors must retire at a certain age; the Cohen Committee on the English Companies Act recommended that directors should not be eligible for election after the age of seventy unless the by-laws made specific provision for this.

Remuneration of Management

The fees paid to directors who are not executive officers of companies are not large; public information in Canada is lacking as to payments to salaried or full-time officers, except in respect of companies which file it with the Securities and Exchange Commission in the United States. Directors

[31] C. A. Ashley, in *Essays in Political Economy* (Ed. H. A. Innis), p. 5.

[32] Baker: *Directors and their Functions*, p. 95.

and the chief officers of companies obtain advance information as to the results of operations and the declaration of dividends, and some of them have made use of such information for personal profit.[33] This raises the moral question of the relationship between directors and individual shareholders; such conduct does not appear to be illegal.

The salaries and bonuses of the management are usually determined by the directors, but if the senior officers of the company are directors, or if they dominate the directors, the management decides its own remuneration. Although bonuses may fluctuate with profits, the total remuneration does not depend directly on profits, and the management is in a very different position from individual enterprise, in which the remuneration is dependent absolutely on profits and becomes negative if the business operate at a loss. ". . . the traditional reward of the business leader—the profit from business ownership—is not a primary incentive to the majority of top executives in our largest corporations."[34] The management enjoys considerable security, and stability of remuneration.[35] During slack times, the management is not reduced in numbers as are the wage earners, nor does its income cease during strikes or lockouts.

The total remuneration of the management of some companies is very high indeed, and the bonus schemes sometimes give the impression that the benefits are more widely distributed than they are in fact;[36] the top management generally receives a very large proportion of any profits shared. The fact that there are comparatively few executive officers of large companies and that dismissals are infrequent, makes the market very narrow; the variations in remunera-

[33] N. J. Silberling: *The Dynamics of Business,* p. 401; A. A. Berle and G. C. Means: *The Modern Corporation and Private Property,* pp. 223-226.

[34] Gordon: *Business Leadership in the Large Corporation,* p. 312.

[35] *Ibid.,* p. 296; Temporary National Economic Committee, Monograph No. 11, p. 110.

[36] See L. L. Lyon, M. W Watkins and V. Abramson: *Government and Economic Life,* Vol. I, p. 67.

tion are very great[37] and there is no principle by which it can be determined. The insistence by the managerial class on market price under free enterprise breaks down when the management is dealing with itself.

The limited company consists of shareholders, directors, management and employees. The original shareholders supply the capital, but from the time the company starts operations, the buying and selling of shares is a market transaction governed by reports, estimates and judgments in respect not only of this company but of the whole capital market. The risk undertaken by the original shareholder is not the same as the risk undertaken by an investor who buys shares in the company years after its promotion and when all the original shareholders are dead; and neither is it the same as the risk of the sole proprietor or partner under individual enterprise. The investor, before buying bonds or shares, may take advice or choose blindfold by sticking a pin into the financial page of a daily paper; he may spend time studying the market and its component parts, or he may pay someone to do this for him. Does this activity entitle the shareholder to receive the net profits of the company? If the management claims that all profits above an average return on capital are due to its efficiency and enterprise, and that it should receive a large proportion of those excess profits, is it prepared to assume that losses are partly the result of inefficiency, and share in them too? Are the employees entitled to expect that excess profits will result in better working conditions, higher wages, and greater security for them? Is the consumer entitled to believe that excess profits should be dissipated for the common good in lower prices? The limited company has been one of the most important institutions in the economy for many years, but these questions still remain unanswered.

[37] Temporary National Economic Committee, Monograph No. 11, p. 90. See also Otto Kahn: *Of Many Things*, p. 158.

The Company and Society

The senior officers of large companies are in a peculiar position. They have great power, but their responsibility is not readily determined. "In the modern corporation, the decisive power, that of the managers, is derived from no one but the managers themselves, controlled by nobody and nothing and responsible to no one. It is in the most literal sense unfounded, unjustified, uncontrolled and irresponsible power."[38] The success and the failure of managers have both brought in their wake controls and alternative systems of public enterprise; stupidity and knavery have both brought discredit to the institution disproportionate to the numbers involved. "Men build organization, and find that the frame of the organization somehow holds them in its grasp. They develop institutions to serve their particular purposes, and they sometimes end by worshipping them."[39] Worship by one group often involves iconoclasm by another, and the economy is threatened by a bitter religious war, with both sides raising the cry of freedom.

To the enormous economic power wielded by officers of large companies is added great political power, which may be exercised through donations to party funds by individuals or out of the monies of the company;[40] by maintaining "lobbies";[41] by ownership of or influence over the press; and by direct corruption. The interchanges that take place between business and political life make it possible for a defeated politician, or a retired civil servant, to find highly remunerative work in business, and for an executive of a company to aspire to cabinet rank. Transfers between politics, the civil service and large companies became a com-

[38] Drucker: *The Future of Industrial Man,* p. 80.

[39] R. M. MacIver: *Social Causation,* p. 320.

[40] House of Commons Special Committee on Beauharnois Power Project: Minutes of Proceedings and Report, No. 21, pp. xix-xxv.

[41] Temporary National Economic Committee, Monograph No. 26 (Economic Power and Political Pressure) Chapter IV; S. D. Clark: *The Canadian Manufacturers' Association* (Toronto: 1939).

monplace during the war. The obvious advantages which resulted may be more than counterbalanced by the equivocal relations that develop between these groups.[42]

"Initiative becomes arrogance; resourcefulness, cunning; efficiency, greed; tenacity, obstinacy; and willingness to take authority and responsibility, pride and lust for power . . . These traits, like any other powerful and dangerous power, must be stimulated, used, and held in check."[43] But how are they to be held in check? Large-scale operations and combination have led to a centralization of power, which makes control both more necessary and more difficult. Some companies have seen the advantages of decentralization of control, and have practised it widely and successfully,[44] but the reduction of the external power of the executive is only slight. More instances could probably be found of centralization being carried to such a degree that the chief executive breaks down and commits suicide, or begins to have extravagant delusions of grandeur.

The division between "public" and "private" companies is unfortunate; a division between large and small companies would free a vast number of small companies from the threat of controls made necessary by the great size of a few companies. These controls might possibly be obviated if self-government within industries[45] could be made effective in time, but any moves in this direction would be viewed with suspicion, legitimate in view of past experience, as a possible attempt at further combination. "The dangers of an obsolescent political structure cannot be avoided by patchwork solutions and plans of the bureaucracies."[46] The same can be said with equal truth of the economic

[42] P. Noel-Baker: *The Private Manufacture of Armaments,* Part II, Chapter III.
[43] B. Ruml: *Government, Business and Values,* p. 14.
[44] See Drucker: *Concept of the Corporation,* Chapter V.
[45] Drucker: *The Future of Industrial Man,* p. 79; Harold Macmillan: *Reconstruction,* Ch. IV. R. Warren: "The State and the Business Organization", in *The State and Society,* Ch. III.
[46] H. A. Innis: *Political Economy in the Modern State,* p. 250.

structure. "It is conceivable—indeed it seems almost inevitable if the corporate system is to survive,—that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity."[47] To decide whether this is the best solution or how it is to be achieved is fortunately not the purpose of this book, but the answer that will be given to this question will have a profound effect on our economic, political and social life.

[47] Berle and Means: *The Modern Corporation and Private Property*, p. 356.

APPENDIX A

Application for incorporation of a company under The Companies Act, 1934

To the Honourable the Secretary of State of Canada.
The application of
respectfully sheweth as follows:—

The undersigned applicants are desirous of obtaining letters patent under the provisions of Part 1 of *The Companies Act, 1934,* constituting your applicants and such others as may become shareholders in the company thereby creating a body corporate and politic under the name of

Limited (*or* Ltd.)

or such other name as shall appear to you to be proper in the premises.

The undersigned have satisfied themselves and are assured that the proposed corporate name under which incorporation is sought is not the name or similar to the name under which any other known company, society, association or firm in existence is carrying on business in Canada or is incorporated under the laws of Canada or any province thereof or so nearly resembling that name as to be calculated to deceive (add, when required by the circumstances: except that of
whose consent to the use of the said name by the proposed company is transmitted herewith) and that it is not a name which is otherwise on public grounds objectionable.

Your applicants are each of the full age of twenty-one years.

The purposes for which incorporation of the proposed company is sought are:

The head office of the proposed company will be situate at in the of

in the Province of , Canada.

The authorized capital of the company is to consist of shares of the par value of $ each (in the case of a company having only par value shares) *or*

The authorized capital of the company is to consist of shares without nominal or par value (in the case of a company having only shares without par value) *or*

The authorized capital of the company is to consist of shares of the par value of $ each and shares without nominal or par value (in the case of a company having both par value shares and shares without par value).

(If the company is to have more than one class of shares, insert particulars of the respective rights, restrictions, conditions and limitations to attach to the shares of each such class.)

(If the company is to be a private company add: Your applicants request that the company be incorporated as a private company with the following restrictions on the transfer of shares:

)

The following are the names in full and the address and calling of each of the applicants:

NAME	ADDRESS	CALLING

The said

will be the provisional directors of the company.

A memorandum of agreement in duplicate in accordance with the statute has been signed by the applicants, one of the duplicates being transmitted herewith.

The undersigned therefore request that a charter may be granted constituting them and such other persons as hereafter become shareholders in the company a body corporate and politic for the purposes above set forth.

Dated at this day of 19 .

Signatures of Witnesses Signatures of Applicants

Memorandum of Agreement

(To be executed in duplicate; one of the duplicates to be transmitted with the application.)

Name of Company

We, the undersigned, do hereby severally covenant and agree each with the others and each of them to become incorporated as a company (*or*, as a private company, as the case may be) under the provisions of Part 1 of *The Companies Act, 1934*, under the name of Limited (*or* Ltd.), or such other name as the Secretary of State may give to the company, with an authorized capital stock consisting of shares of the par value of $ each (*or* shares without nominal or par value, *or* shares of the par value of $ each and shares without nominal or par value, as the case may be).

(If the company is to have more than one class of shares, insert: The respective rights, restrictions, conditions and limitations to attach to the said and the said in the capital stock of the company are set out in the application for incor-

poration of the company dated 19 made by the undersigned to the Honourable the Secretary of State of Canada subject to such modifications and variations as may be required by the Secretary of State).

(If the company is to be a private company, insert: The restrictions on the transfer of shares of the company are to be as set out in the application for incorporation of the company dated 19 made by the undersigned to the Honourable the Secretary of State of Canada).

And we do hereby severally, and not one for the others or other, subscribe for and agree to take the respective shares of the capital stock of the said company set opposite our respective names as hereunder and hereafter written and to become shareholders in such company to the said amounts.

Witness our hands and seals.

Name of subscriber	Seal	Number of shares subscribed for[1]	Date and place of subscription		Residence of subscriber	Name of Witness
			Date	Place		

[1]If the company is to have more than one class of shares, specify the class of shares subscribed for.

APPENDIX B

Copy of a representative Proxy Form

If unable to be present in person at the said meeting, it is hoped that you will sign and return the accompanying form of Proxy to the Secretary of the Company, without delay, in the envelope enclosed herewith.

The Consolidated Mining & Smelting Company of Canada, Limited

PROXY

KNOW ALL MEN BY THESE PRESENTS that the undersigned shareholder of The Consolidated Mining and Smelting Company of Canada, Limited hereby constitutes and appoints S. G. BLAYLOCK, and/or R. E. STAVERT, the true and lawful Attorney or Attorneys, Agent or Agents and proxy or proxies of the undersigned, with full power of substitution, for and in the name, place and stead of the undersigned to vote upon and act with respect to all the shares of the capital stock of The Consolidated Mining and Smelting Company of Canada, Limited, standing in the name of the undersigned at the Annual General Meeting of the Shareholders of the said Company to be held at the Board Room of the Canadian Pacific Railway Company, Windsor Station, in the City of Montreal, on Thursday, the 29th day of April, 1943, at the hour of 12.00 o'clock noon, notice of which meeting is hereby acknowledged, and at any and all adjournments thereof with all the powers the undersigned would have if personally present at such meeting, or any such adjournment or adjournments.

The undersigned hereby ratifies and confirms all that the said Attorneys, Agents and proxies or any of them may do by virtue hereof.

WITNESS the hand of the undersigned this
day of April, 1943.

In the case of a Shareholder which is an incorporated company the corporate seal should be affixed to ensure valid execution.

APPENDIX C

Extract from Trust Agreement in connection with bond issue of the Canadian Pacific Railway

The Bonds of this issue may be redeemed, in whole or in part, at the option of the Railway Company, on any interest date, upon at least sixty days' prior notice published in two daily newspapers printed in the English language, one published and of general circulation in the City of Montreal, Province of Quebec, Dominion of Canada, and one in the Borough of Manhattan, City of New York, State of New York, United States of America, at 104 per cent. of the principal amount thereof on or before July 1, 1940; at 103 per cent. of the principal amount thereof after July 1, 1940; and on or before July, 1945; at 102 per cent. of the principal amount thereof after July 1, 1945, and on or before July 1, 1950; at 101 per cent. of the principal amount thereof after July 1, 1950 and on or before July 1, 1955; at 100½ per cent. of the principal amount thereof after July 1, 1955 and on or before July 1, 1959; and at 100 per cent. of the principal amount thereof after July 1, 1959 and prior to maturity; accrued interest on the principal amount to be paid in each case to the designated date of redemption.

APPENDIX D

Profits and Dividends[1]

Many writers on business finance have dealt with this subject, and some have realized that it has importance to interests wider than those of the corporation itself. Many writers have been dogmatic and some have also been inconsistent. "That, in the normal case, it is unwise for the management of a business enterprise to pay out in dividends to stockholders each year all of the shareholders' surplus or net income, practically every person who has a right to an opinion on this matter would agree."[2] This author, however, also arouses proper doubts in the mind of the reader: "Probably the outstanding motive prompting managers of business enterprises to undertake to expand them is the feeling that they would be more in their element if they were managing a concern which is larger and more complex."[3]

"It has commonly been stated by conservative financiers that a well-managed concern should put back into the business one dollar for every dollar declared in dividends."[4] Conservative financiers are unfortunate in that they often have attributed to them rules of thumb involving simple round numbers. Such a rule as this would, of course, result in tremendous automatic industrial expansion on a somewhat indiscriminative basis. ". . . it may be broadly stated that the particular display of incompetence or bad judgment which leads to financial difficulties manifests itself almost uniformly in one way—*overextension.*"[5] "At the beginning of periods of depression following general overexpansion,

[1] Reprinted from *The Commerce Journal* (University of Toronto), March, 1941 and April, 1942.
[2] A. L. Bishop: *The Financing of Business Enterprise* (New York, 1929), p. 480.
[3] *Ibid.*, p. 491.
[4] E. E. Lincoln: *Applied Business Finance,* p. 754.
[5] *Ibid.*, p. 762.

difficulties and failures are multiplied."[6] One concludes that as long as "conservative financiers" have their way, extreme industrial fluctuations are inevitable!

The reasons advanced for building up surpluses by retention of profits are usually: (1) to equalize dividends, (2) to withstand depressions, (3) to maintain the credit of the company, (4) to enable a gradual growth to take place, (5) (less frequently) to maintain wages in bad times. Few writers have attempted to bring evidence that such policies have been successful.

The equalization of dividends primarily affects shareholders, but it also has a more general interest. In earlier times investors were expected to exercise discretion: if they wished for security, they bought government bonds; if income was of a little greater importance, they bought industrial bonds; if income was of much greater importance, they bought preference shares; if they were prepared to accept capital risks in return for a chance of high income, they bought common shares. This is, of course, an oversimplification, but the picture would now be completely changed if some writers had their way. "But the stockholders expect a steady return upon their investment."[7] The belief that regular dividends are desirable is certainly widely held, but shareholders are not quoted in support of it. "The well-intentioned management is admonished by all parties, *except perhaps by the shareholders themselves,* to stabilize dividends."[8] The application of this principle that dividends should be equalized is somewhat one-sided; profits are withheld in good times and dividends are consequently lower than they might be, but the dividends are not maintained in bad times to a fraction of the amount withheld in good times. ". . . dividend payments become

[6] *Ibid.*, p. 763.

[7] S. H. Slichter: *Modern Economic Society* (New York, 1931), p. 671.

[8] J. E. Amos: "The Economics of Corporate Savings" (*Studies in Social Sciences of Illinois University,* 1937), p. 73.

close to a fixed return . . . in the sense that the volume of dividend disbursements *for industry as a whole* is not likely to drop substantially even during periods of depression."[9] This author gives a table showing that from 1909 to 1926 dividends exceeded profits only in one year. A few years later companies failed to pay the dividends for which they had supposedly made provision during this period. "The pundits of 'sound financial practice' who recommend the stabilization of dividends will be interested in the small part of the accumulations of this period which were paid out in dividends after 1929: promises were not fulfilled . . . so called 'reserves' are often used to expand the business in which event cash ceases to be available."[10] This quotation serves to join two points which are not usually as closely related as they should be: stabilized dividends and availability of funds; the availability of funds is also of great importance in the retention of profits to withstand depressions.

If profits are to be retained with the intention of using them in cash at a future time, they must be retained in cash or in liquid securities, which necessarily yield a low rate of interest. The shareholder may well feel that he is as able to invest his profits, or to decide whether to invest them, as is a company director. "The surplus retained may be largely kept in cash or in more or less liquid investments."[11] "The stockholders presume—and this presumption should be true if the business is successful—that the officials can invest the surplus in their own business better than in another of which they know little. They cannot be expected to take the surplus and invest it in open market securities, for the reason that being engaged in a business requiring in itself careful attention to details, a close attention to the stock market is the last thing that should be demanded of them. So that

[9] Slichter: *Modern Economic Society*, p. 672.
[10] R. S. Edwards, in a review in *Economica*, Feb., 1939, p. 107.
[11] Lincoln: *Applied Business Finance*, p. 747.

the surplus is at best merely an accounting affirmation: it is not a fund from which stockholders may draw dividends during times of lessened earnings such as the depression following 1929."[12] "The past record of corporate investments does not indicate that managements are successful investors because they are good operators. Much evidence points to the contrary conclusion. . . . Further, the practice of making outside commitments leads readily to abuse. Purchases and sales may be made with a view to influencing securities in which the managers are individually interested. . . . As a general rule the stockholders should be given the unneeded earnings. If they lose them in subsequent commitments, they at least have the memories."[13]

The argument advanced in favour of regular dividends leads in the end along a curious path, and it is perhaps as well that the argument is so often a rationalization of policy and that the path is, in fact, seldom followed. The investment of company profits in liquid securities would introduce artificial fluctuations quite gratuitously into the economic system. The effect of this policy on the trade cycle is certainly not as simple as the following quotation suggests: "If industry pays out a large portion of these profits as dividends, in accordance with the amounts earned each year, it will tend to increase the total purchasing power at the various times when business is expanding. The money thus distributed will enable buyers to offer more for the supply of goods available and tend to raise prices and expand business still further. But if industry adopts a policy of paying out profits on a stabilized basis, whereby earnings are accumulated in good years and distributed evenly over good and bad periods, a retarding force will be applied when business is expanding and a sustaining influence brought to

[12] A. S. Dewing: *Financial Policy of Corporations* (New York, 1934), p. 603.
[13] K. Field: *Corporation Finance* (New York. 1938), p. 457.

bear when activity declines."[14] This is perhaps true if the fund for equalizing dividends is hoarded in cash; if it is used to buy securities it will not exercise a retarding force when business is expanding. The decision whether to spend on consumption, to hoard, or to buy securities could be left with equal confidence to the shareholders. "The reserves which are accumulated are not allowed to lie idle; they are employed either in what are really capital extensions of the business, or in the purchase of outside securities, and in either case they represent an increase in the total supply of capital."[15]

The creation of a surplus so that a company may meet a depression with greater confidence also requires that the surplus should be in liquid resources, because the depression will become evident first in dwindling working capital. If the company has ploughed in its surplus through expansion of operations, it will probably be in a worse rather than a better position to meet a depression. "Further, it is absolutely essential at all times to pay out less than is earned, and in good years to 'plough in' a large proportion of the earnings in order to strengthen the company for the inevitable 'lean' years."[16] Quotations from standard works are like proverbs: one can be found to support almost every view. "It is certain, furthermore, that the overexpansion of fixed assets, which characterized the latter period [1926-30], was due in no small measure to the disinclination of directors to relinquish earnings to stockholders."[17] The use of its surplus for expansion of a company's operations results in involuntary investment by the shareholders in a particular industry; the policy may be successful or it may be disastrous for the shareholders. The companies which accumulate liquid re-

[14] D. E. Wilbur: "A Study of the Policy of Dividend Distribution" (*Harvard Business Review*, vol. X, p. 374).

[15] H. D. Henderson: *Supply and Demand* (London and Cambridge, 1922), p. 136.

[16] Lincoln: *Applied Business Finance*, p. 738.

[17] Dewing: *Financial Policy of Corporations*, p. 616.

sources for this purpose are not typical.[18] If a company is going to accumulate liquid resources first to equalize dividends and secondly to meet the lean years, and if general expansion is to be avoided by keeping the funds in cash, an enormous change in the economic system will be required. No evidence suggests that company directors or managers have any particular competence in dealing with the economy as a whole or that they are acting within the reasonable scope of their duties in withholding profits from shareholders. "It is improper for the directors of a public corporation to pursue this policy. The company has applied to the investor to furnish funds for their enterprise. The money has been contributed with the understanding that if profits were earned they would be distributed in dividends, so far as a distribution could safely be made."[19] "*Assuming that the reported earnings were actually available for distribution*, then stockholders in general would certainly fare better in dollars and cents if they drew out practically all of their earnings in dividends."[20] "But in corporations, especially in the larger concerns, change of ownership is the normal thing, and it seems only proper that each 'generation' should 'pay its own way' and that each 'generation' should realize its own profits."[21]

The view is frequently advanced that a company which pays regular dividends has prospects of obtaining short- or long-term funds on better terms than would be available if its dividends fluctuated. "It is a well-known fact that if any particular stock has a long record of stable and regular dividend payments . . . the company that has issued it will be able to secure whatever long-term or short-term capital it may need in the future on favourable terms. But it is

[18] See M. S. Kendrick: *The Undistributed Profits Tax* (Washington, 1937), p. 33.
[19] E. S. Mead: *Corporation Finance* (3rd ed., New York, 1926), p. 270.
[20] B. Graham and D. L. Dodd: *Security Analysis* (New York, 1934), p. 330.
[21] C. W. Gerstenberg; *Financial Organization and Management* (New York, 1928), p. 295.

also a matter of almost common knowledge that, even though a constant and uniform rate of dividend is desirable under most circumstances, the earnings of any particular company that has adopted such a dividend policy are subject to considerable fluctuations from year to year."[22] With the methods of share flotation that have been in use, a regular dividend may be attractive; the requirement of the English Companies Act,[23] that a prospectus must contain an auditor's report of profits in each of the past three years, might, however, give more useful information. "If capital cannot be obtained at the market rate, then it is a sign that investors think that capital has a greater productivity elsewhere."[24] The "productivity" is based on estimates of future earnings in the light of past experience, and to refer prospective investors to a record of regular dividends is deceptive. If it is true that short-term credit is more easily obtained when regular dividends have been paid, this suggests that bankers are prejudiced in favour of a particular type of managerial conduct which has little to do with the risk they are offered.

The arguments in favour of expansion through retention of profits are various and inconclusive. "The great advantage, on the other hand, of securing capital through savings consists of the steadiness and soundness with which the business may in this way be developed. It will not suddenly spurt ahead—perhaps before adequate preparation has been made or before an effective organization can be brought together. It will grow, year by year, adding a new piece of machinery here, erecting an addition to its plant there."[25] Fear is here expressed that a large-scale expansion will be ill-planned, but a gradual growth such as is outlined may, in the end, be chaotic. "But the convenient times for accumulating undistributed profits will not coincide with the

[22] Bishop: *Financing of Business Enterprise*, p. 485.
[23] Companies Act, 1929, Section 35 and Fourth Schedule.
[24] R. F. Fowler: *The Depreciation of Capital* (London, 1934), p. 110.
[25] T. Conyngton *et al.*: *Corporate Procedure* (New York, 1922), p. 919.

convenient times for extending the capital equipment. . . . The extension of capital equipment will for the most part consist of relatively considerable operations at intervals of some years."[26] The capital market is not particularly well organized to deal with entirely new ventures or small companies[27] and they may be justified in expansion through savings, while private companies (in which ownership and control more nearly coincide than in public companies) may be left to expand as they wish; but whenever possible the financing of expansion should be made to pass the test of the capital market. "A company, the earnings of which fluctuate widely, is, on the face of it, engaged in a speculative business and cannot easily secure fresh capital on favourable terms. Only through accumulations out of earnings can the business be extended and stabilized."[28] This assumes that the expansion should be made, but that investors who cannot be persuaded of the fact should be forced into further speculative investment. If capital is not available for speculative investment, this may be due in part to the carefully cultivated view that dividends should be constant, but little evidence is available that speculation has lost its attraction, although investors may not always be in that mood. "Now a third stage is being reached where inducements to private owners to risk their property can no longer avail against timidity and inertia to obtain the increasing supplies of capital that are necessary. Recourse is had to a veiled forced levy on capitalist dividends by re-investment on the part of administrators and directors."[29] Cause and effect may be confused, but there is no doubt that the veiled forced levy is an old method, whose use has increased very rapidly, and

[26] R. G. Hawtrey: *Capital and Employment* (London and New York, 1937), p. 93.

[27] In fact, large companies appear to plough in a larger percentage of profits than do small companies. See N. S. Buchanan: "Theory and Practice in Dividend Distribution" (*Quarterly Journal of Economics*, Nov., 1938, p. 88).

[28] W. H. Lough: *Business Finance* (New York, 1917), p. 471.

[29] P. S. Florence: *The Logic of Industrial Organization*, p. 187.

which has undoubtedly prevented shareholders from exercising a free choice or showing timidity.

A questionnaire sent to almost one thousand companies in the United States in connection with the Undistributed Profits Tax produced some curious replies. "We have not yet decided to build the plant and one of the principal reasons a decision has not yet been reached is because it would appear necessary to raise perhaps half a million dollars . . . by the sale of additional common stock. . . . Naturally there is some question about the advisability of increasing the amount of outstanding stock on which the company will need to earn in future years."[30] Apparently, however, the management would have had no compunction in reinvesting the profits, although this would have been quite as real an investment on the part of shareholders as would have resulted from the sale of additional shares. The Radio Corporation of America earned $48,500,000 on its common stock between 1919 and 1929, but paid no dividends. "The rapid expansion of the company in the radio, talking machine, broadcasting, motion picture and equipment fields made the reinvestment of earnings desirable as a source of capital."[31] But the authors tell us that the company operated at a deficit from 1930 to 1935, and this raises doubts whether the expansion was desirable or, at any rate, well timed.

The argument that reserves are built up for the maintenance of wages in bad times need not be taken very seriously, but it was used against the Undistributed Profits Tax. "It has been the policy of the company for years to set aside a portion of its earnings to provide for the payment of wages and dividends in lean years. . . . Without these reserve savings to draw on the company would have had to greatly

[30] Kendrick: *Undistributed Profits Tax,* p. 42.

[31] H. G. Guthmann and H. E. Dougall: *Corporate Financial Policy* (New York, 1490), p. 539.

decrease its payroll."[32] Against this the Director of Research and Statistics of the United States Treasury is quoted: "Not only do we know that the corporate surpluses accumulated in the twenties were not used to any great extent, in the aggregate, to maintain employment during the depression but we also have some ground for suspecting that the accumulation of these very corporate surpluses assisted materially in causing the depression."[33] The suggestion that "a considerable number of companies use their surplus to stabilize the sale price of their products"[34] need not detain us. Some companies have taken the view that the tariff should be adjusted so that a fair return may be earned on all the capital invested in the business, and this capital often includes profits which have been retained within the company. The company pays low dividends while building up its surplus, and as attention is directed to dividends rather than to profits, the tariff protection may not be challenged; later, the company demands the maintenance or increase of the tariff to enable it to earn profits on expansion which may have been ill-advised, and which has not passed the test of the capital market. The arguments used in support of a claim for a tariff increase are not always compatible with the policy of expansion that has taken place. "Viewing the Company's earnings in relation to the value of its investment, its earnings have been entirely inadequate . . . [the protection] is not sufficient to assure to that industry a fair yield on its investment having in view the risks involved."[35] In spite of this claim of inadequacy of earnings, this company and many others in the industry had consistently retained profits for expansion, whereas on this argument the shareholders would have been better off had they received

[32] Kendrick: *Undistributed Profits Tax*, p. 35.
[33] *Ibid.*, p. 87.
[34] *Ibid.*, p. 40.
[35] Quoted in *Report of Royal Commission on the Textile Industry* (Ottawa, 1938), p. 121.

dividends and invested elsewhere. "To deny a fair return on surplus earnings left in the business puts a penalty on conservative business practice."[36] Surely such a statement cannot be taken seriously; "conservative business practice" cannot safely be substituted for sound business judgment, or expect protection from its inherent faults. Some writers maintain that a company which does not advance must retreat. "Corporations which fail to grow from year to year in moderate proportion are doomed to extinction."[37] The history of companies, however, probably shows more failures through expansion than through failure to expand. "The more successful a corporation may be, the less it has to gain by the problematic success of a programme of expansion and the more it has to lose by the failure of a programme of expansion."[38] The final responsibility for the policy of the company is sometimes laid on the shareholders. "If we assume that the accumulation of surplus is known to the public, then we must suppose that a majority of the stockholders are in agreement with the saving policy, and the fundamental difference between corporate savings and individual savings is not great. . . . The small stockholder . . . if he is greatly dissatisfied with the decision of the directors to retain the surplus, may sell his stock. If the new owner knows the policy of the corporation, his purchase is evidence of his willingness to have the profits retained in his business."[39] The validity of this argument is doubtful, for it supposes more knowledge, care, and initiative on the part of small shareholders than is common, and also supposes alternative investment opportunities in companies whose directors distribute profits as earned. Dividend policy is not the only factor in investment decisions. "If the directors,

[36] J. H. Bliss: *Financial and Operating Ratios in Management* (New York, 1923), p. 181.

[37] Quoted in Kendrick, *Undistributed Profits Tax*, p. 34.

[38] Dewing: *Financial Policy of Corporations*, p. 932.

[39] F. B. Garver and A. N. Hansen: *Principles of Economics* (Boston, 1937), p. 449.

using their power, force the shareholders to tolerate this policy of reinvestment of earnings, the responsibility rests entirely on the shoulders of the directors."[40]

An argument not often advanced in favour of restricting dividends is that a company may use its surplus to reduce its funded debt and thus avoid the burden of fixed charges in bad times. This policy does not increase total investment in the company and may recommend itself to shareholders in a company subject to fluctuations, but if such a policy is advisable, that fact is a criticism of the original capital structure of the company and should throw doubts on the capacity of the promoters and early directors.

Economists have acknowledged the quantitative importance of profits retained by companies, but do not seem to have made any systematic attempt to discover what qualification of their customary analysis is involved. They have not, of course, been prepared to accept the common business point of view. "It may be a mistake for a firm, however efficient within the bounds of any one line of product, to invest capital in the same line of production or even to use its capital to develop other lines by lateral or vertical expansion."[41] "It is the profit of the shareholders that it is the directors' duty to promote with a single mind. . . . But realities have a way of differing from forms, and just as in political affairs it is common to regard the State as a very different thing to the people who compose it, as a sublime entity with a separate existence of its own, so directors and managers of a large public company are apt to distinguish between the company and the shareholders. To pay away in dividends to shareholders money which they could employ in extending the business or strengthening the position of the company appears to some directors a necessity hardly less pleasant than an increased wages bill,

[40] Dewing: *Financial Policy of Corporations*, p. 617.
[41] Florence: *Logic of Industrial Organization*, p. 192.

or an Excess Profits Duty."[42] The author devotes two pages to Involuntary Savings, but does not analyse its effects. Keynes acknowledges the difference in motives between individuals and companies,[43] but does not suggest how the difference affects what he calls Propensity to Consume, Incentives to Liquidity, and Marginal Efficiency of Capital; nor does he mention retained profits in his important chapter "Sundry Observations on the Nature of Capital".

Two arguments put forward by economists in favour of retaining profits are well worth recording. "In part this policy arises from a well-founded belief that what are called profits by accountants are not necessarily profits in an economic sense."[44] This is particularly true when the conventional valuation of inventories is used during a time of fluctuating prices. "So long as the prospective return from further capital investment in the enterprise is not less than the rate of interest on alternative investments of equivalent risk, the directors may properly increase the employed capital by reinvesting earnings."[45] This assumes a far greater knowledge on the part of directors than is reasonable; the application of this principle would probably make practically no change in current practice, for most directors would readily persuade themselves that they were acting well within its limitations. The same author writes: ". . . it is common knowledge that there has been considerable overextension of plant in certain industries, which has been in part financed out of reinvested earnings,"[46] and later: "It might often be eminently wise for the corporation gradually to disinvest and return to the shareholders the funds they committed instead of continuing on in an unprofitable ven-

[42] Henderson: *Supply and Demand*, p. 135.

[43] J. M. Keynes: *General Theory of Employment, Interest and Money* (London, 1936), p. 108.

[44] A. R. Burns: *The Decline of Competition*, p. 420.

[45] N. S. Buchanan: *The Economics of Corporate Enterprise*, p. 234.

[46] *Ibid.*, p. 237, f.n.

ture",[47] but this view is not likely to commend itself to the management receiving salaries from the company. The book from which these last three quotations are taken makes an attempt to fit corporate enterprise into a complete system of economic analysis; in spite of the importance of the problem, the author is doing pioneer work. The trust placed by some writers in the operation of the capital market (and suggested earlier in this article) is perhaps exaggerated. "Proposals to substitute the judgment of the capital market for that of private business executives in the expansion problem imply an equilibrating magic of the market which may be more apparent than real."[48] Unfortunately a good deal of economic writing is shot through with similar magic.

The importance of retained earnings as a source of increase in investment may be emphasized by a few short quotations. "Of the 957 corporations replying to this question, 866 said that they had made use of surplus accumulations to finance business expansion."[49] "In Britain and in the United States, as indeed in all the most advanced industrial nations, this type of saving is the main source of new funds for the development of industry and trade."[50] "It is well known that the principal source of savings under modern conditions is in the undistributed profits of companies and firms (including private companies)."[51] "Lastly, profits put back into business. This is by far the most important item of all."[52] Mr. Stollery states that figures for approximately seventy-five Canadian companies show that earned surpluses amount to 8.8 per cent of the total assets. "Total earned surpluses would undoubtedly bulk larger

[47] *Ibid.*, p. 248.

[48] P. M. Van Arsdell: "Corporate Surplus Policy as a Function of Monopoly" (*Accounting Review*, Sept., 1940, p. 326); see, however, H. von Beckerath: *Modern Industrial Organization* (New York, 1933), p. 73, and Burns: *Decline of Competition*, p. 10.

[49] Kendrick: *Undistributed Profits Tax*, p. 33.

[50] J. A. Hobson: *Wealth and Life* (London, 1929), p. 279.

[51] C. Clark: *National Income and Outlay* (London, 1937), p. 185.

[52] A. T. K. Grant: *A Study of the Capital Market in Post-War Britain*, p. 122.

had not re-capitalization of many of these companies concealed the proportion of the total assets created by savings of the corporations in their earlier days."[53] A great deal of research would be necessary to discover the true total.

The motives of directors in formulating their dividend and surplus policy are by no means the same as the motives which guide an individual in deciding between spending and saving; nor is it likely that the directors are fully conscious of their motives or able to state them accurately (in this they are not different from the majority of people). Probably almost all directors believe that their policy is in the best interests of the company, although some would differentiate between the company and the shareholders. We have seen that directors claim that the good management of surplus may involve the equalization of dividends, the maintenance of a liquid position, security against depressions, and even the payment of wages when they cannot be earned and the sale of goods at uneconomic prices. The analysis of their motives by others, however, leads to different conclusions. "The most powerful motive that leads a man to expand a business is the illusion of valuing himself in terms of his setting. The bigger the business, the bigger the man."[54] "A bigger plant, a larger catalogue of products, ministers to the manager's pride, and perhaps to his salary."[55] "The officers . . . are also inclined to expand the business persistently for the sake of personal aggrandizement and to secure higher salaries. This is a leading cause of the unwise increase of manufacturing facilities which has proved recurrently one of the chief unsettling factors in our economic situation."[56] "The motive of improvement—to secure a gradually increasing income, which, incidentally, will protect the man-

[53] "Canadian Corporate Savings" (*Canadian Investment and Foreign Exchange Problems*, ed. J. F. Parkinson, p. 222).

[54] Dewing: *Financial Policy of Corporations*, p. 695.

[55] E. L. Heemance: *Can Business Govern Itself?* (New York, 1933), p. 42.

[56] Graham and Dodd: *Security Analysis*, p. 230.

agement from criticism, since increasing income due to accumulation is seldom distinguished from increasing income due to efficiency."[57]

The opinions expressed by business and financial men have led many into an uncritical belief that the retention of profits and the creation of unnecessary reserves are always praiseworthy. "It is extremely difficult, however, to persuade business men to accept policies which go against conventional business practice, even though those policies might be in their own interests."[58] ". . . those managements which, by inheritance, tradition, or training have acquired the belief, attaining almost the strength of a religious conviction, that the only sound policy for any management to follow is that of continually 'plowing back' earnings into the business enterprise regardless of countervailing factors."[59]

A thorough statistical analysis requires a great deal of time, and the information available to the public is not always satisfactory: many Canadian companies did not issue statements which were suitable for proper analysis before the changes in the Dominion Companies Act in 1934 and 1935, and a whole day spent on one company would not enable anyone to present an accurate statement of source and application of funds for a period starting earlier than 1935. However, an attempt has been made to summarize the profits and dividends of certain companies, and to relate these to some of the writings quoted; the use of surplus for the maintenance of dividends has been examined; and some observations have been made on the use that has been made of profits retained by the companies. The main source of information has been the *Financial Post* Surveys of Corporate Securities.[60]

[57] Keynes: *General Theory of Employment, Interest and Money*, p. 109.

[58] L. G. Reynolds: *The Control of Competition in Canada*, p. 78.

[59] G. H. Sage: "Dividend Policy and Business Contingencies" (*Harvard Business Review*, vol. XV, p. 245).

[60] Use has been made of figures prepared from this source in 1940 by Mr. D. G. Tyndall.

Sixty-five companies were examined for the interesting period between 1928 and 1941. The analysis is obviously far from complete and a very much larger number of companies was not touched, including such important sections as Public Utilities, Construction, Milling, and Pulp and Paper.

SUMMARY OF COMPANIES RETAINING PROFITS

Fifty-two companies whose profits exceeded their dividends were examined; their profits for the whole period were a billion dollars and their dividends were six hundred and eighty million; profits retained were three hundred and twenty million. New capital issued amounted to seventy-five million dollars, half of it being issued in the period 1928-31; and twenty-two million dollars of capital was redeemed.

"It has commonly been stated by conservative financiers that a well-managed concern should put back into the business one dollar for every dollar declared in dividends."[61] By this criterion sixteen of the companies were well managed, although two or three show little other sign of it. Shareholders who subscribed new capital in 1928 to one of the companies had seven years without dividends and five years of much lower dividends than those previously earned.

"But the stockholders expect a steady return upon their investment."[62] Their expectations were fulfilled by, perhaps, six companies, two of which had very steady profits and one of which paid no dividends on its common shares until it had redeemed its preference shares out of profits. All the other companies reduced their dividends (usually within a year) when profits fell; some of them had large investments in marketable securities available to continue dividends, and some of these were sold at a loss. "*Assuming that the reported earnings were actually available for distribution*, then

[61] E. E. Lincoln: *Applied Business Finance* (Chicago and New York, 1925), p. 754.

[62] S. H. Slichter: *Modern Economic Society* (New York, 1931), p. 671.

stockholders, in general, would certainly fare better in dollars and cents if they drew out practically all of their earnings in dividends."[63]

"It is well known that the principal source of savings under modern conditions is in the undistributed profits of companies and firms . . ."[64] In the fifty-two companies undistributed profits were four times as large as new capital issues, and half of the new capital belonged to the investment boom which was broken in 1929. A large proportion of the later capital issues was to finance the expansion of Distillers-Seagrams' business.

Summary of Companies Distributing Dividends in Excess of Profits

Thirteen companies were examined. Total figures are not as significant as those for the fifty-two companies dealt with in the last section, and generalization is less easy or useful. Imperial Oil swamps the other companies; it made large profits every year and its excess dividends were the result of a policy of disinvestment. Canadian Cottons also made profits every year and maintained its preference dividends although it stopped paying common dividends two years after dividends exceeded profits. Dominion Bridge made profits every year but reduced its dividend four times. All the other companies made losses at some time during the period, and all of them reduced their dividends within one or two years of profits showing a marked fall. Ignoring Imperial Oil, these companies issued over twenty-five million of new capital in the three years 1928-30; Massey-Harris being responsible for fourteen and a half million, and making a loss for the seven years after the issue.

Iron and Steel Industries

A. Twenty of the companies examined made profits in

[63] B. Graham and D. L. Dodd: *Security Analysis* (New York, 1934), p. 330.
[64] C. Clark: *National Income and Outlay* (London, 1937), p. 185.

excess of dividends paid; the periods covered are 15 years for one company, 14 years for thirteen companies, 13 years for four companies, and 12 years for two companies, ending with 1940. Comments are made on some individual companies.

(Thousands of dollars)

Profits 174,431; Dividends 112,327; Retained 62,104.

Beatty Brothers, Ltd. (12 years). At the end of 1930 there was a surplus of two and a quarter million dollars and a bank loan of seven hundred thousand. In 1931 profits fell and the common dividend was reduced, but total dividends exceeded profits. In 1932 a small common dividend was paid when profits were negligible. A loss was made in 1933 and a small profit in 1934, and preference dividends were maintained. Common dividends were not resumed, and the profits of the whole period exceeded dividends by eight hundred thousand dollars. Inventories increased; bank loans increased; and some preference shares were redeemed.

Canada Iron Foundries, Ltd. (14 years). The preference shares are non-cumulative and in 1932, when profits were reduced, the preference dividend was halved although there were call loans, more than three times the amount by which the dividend was reduced, and investments of almost three million dollars on hand. In 1933 and 1934 profits exceeded the full amount of the preference dividend but only half was paid, and over four hundred thousand dollars of bonds were redeemed. Again in 1936 and 1937 the profits were sufficient for the full preference dividend but only part was paid. Profits for the period exceeded dividends by over one and a quarter million dollars; investments increased and bonds were paid off.

Canada Wire and Cable Co., Ltd. (12 years). In 1931 and 1932 new capital of a million dollars was subscribed and

fixed assets were gradually expanded, some funds being used to increase marketable securities. Dividends exceeded profits in 1931; the preference dividend and a much reduced common dividend were paid in 1932 when a loss was made, and by this time the marketable securities had depreciated heavily. This depreciation was written off in 1935 against common share capital, and at the same time fixed assets were reduced by over one and a half million dollars by a charge against common share capital. The income accounts for the period show profits in excess of dividends to the extent of over one and a quarter million dollars.

Canadian Car and Foundry Co. Ltd. (13 years). New capital was issued in 1929 and bonds to about the same amount paid off. A heavy reduction in profits in 1931 brought a reduction in common dividends although there were surplus and government bonds far in excess of dividends usually paid. In 1932 the common dividend was reduced to a very small amount; a little capital was redeemed in 1932 and 1933 and in both years a loss was made. Preference dividends were paid throughout the period and profits exceeded dividends by six hundred thousand dollars. Common dividends were resumed after three years of profits in excess of preference dividends.

Canadian General Electric Co., Ltd. (14 years). No common dividends were paid from 1924 until 1930 by which time surplus was six million dollars and investment in government bonds eight million. Dividends in excess of profits were paid in 1932, 1933, and 1934, but common dividends were reduced in 1933, again in 1934, and not raised in 1935 in spite of good profits. In 1935 the preference shares were redeemed (eight and a half million dollars including premium) but government bonds and other marketable securities of over eleven million dollars remained on hand; a condition which has continued to 1941. Profits for the period exceed dividends by fifteen and a

half million dollars, being divided almost equally between dividends and funds retained. Investments and inventories were increased and preference shares were redeemed.

Canadian Westinghouse Co., Ltd. (14 years). Dividends exceeded profits for the five years 1932-6, but dividends were reduced for these years although in 1932 surplus and investments each amounted to seven and a half million dollars. In 1939 a further reduced dividend slightly exceeded profits when surplus and investments exceeded four years' dividends at the previous rate. Profits for the period exceeded dividends by over four and a half million dollars, and inventories and investments were increased by a large amount.

Dominion Foundries and Steel, Ltd. (14 years). Preference dividends were maintained in 1932, when profits were reduced almost to zero, and left the company short of cash. From 1935 to 1939 profits were much in excess of dividends and over the whole period profits exceeded dividends by three million dollars. New capital of one and a half millions was issued from 1937-40 and inventories and fixed assets were increased.

Dominion Steel and Coal Corp., Ltd. (13 years, including British Empire Steel for 1928 and 1929). A small dividend was paid by the earlier company in 1929. New capital of five million dollars was issued in 1939 to acquire the shares of Nova Scotia Steel and Coal. Net profits for the whole period were over six million dollars. In the last four profitable years accounts receivable and inventories increased; no dividends have been paid since 1929.

Eastern Steel Products, Ltd. (14 years). Preference dividends were maintained for four years (1932-5) in excess of profits, and common dividends were paid in 1932 and 1936 when total dividends exceeded profits. Profits for the period exceeded dividends by over three hundred thousand dollars, and preference shares of two hundred and fifty thousand were redeemed.

Ford Motor Co. of Canada, Ltd. (15½ years). Six million dollars of new capital was issued in 1929. From 1926 to 1934 profits showed extreme fluctuations, the extremes being profits in 1929 of over five million dollars and losses in 1932 of the same amount. Dividends fluctuated violently until 1936 and have since been constant. Profits for the whole period exceeded dividends by four million dollars; during the last five years of steady dividends and almost steady profits, profits exceeded dividends by over seven and a half million dollars. During this five years the following were the chief changes in thousands of dollars (round figures).

Increases		*Decreases*	
Accounts Receivable	4,000	Accounts Payable	7,500
Inventories	8,500	Tax Payable	2,500
Invest. in Affiliates	5,000	Invest. in Bonds	9,000
Fixed Assets	11,000		

International Metal Industries, Ltd. (13 years; formerly Service Stations, Ltd). Preference dividends were paid in 1931, when a very small profit was earned, and were continued for part of 1932 when a loss was made but when cash, investments and surplus were adequate to cover full dividends. Two and a half million dollars of new capital was issued in 1929-30. Net profits for the whole period were over four and a half million dollars; 17 per cent of the profits were retained.

National Steel Car Corp., Ltd. (14 years). New capital of two and a quarter million dollars was issued in 1929. Dividends were reduced in 1932 when profits fell heavily; and a small dividend was paid in 1933, when a loss was made. Funds and surplus were available at this time but were drawn on heavily during three years of losses. Larger dividends than were paid in 1938, 1939 and 1940 could have been paid, but the funds available were used for expansion, together with new capital of one and a half

million dollars in 1939. Profits for the whole period (three million six hundred thousand) were divided equally between dividends and funds retained.

Page-Hersey Tubes, Ltd. (14 years). Over half a million dollars of new capital was issued in 1928. A heavy fall in profits in 1932 brought a reduction in dividends, although in 1932 and in 1933 dividends exceeded profits. There was a surplus of over two million dollars and an equivalent amount of marketable securities on hand in addition to a large call loan. The profits for the whole period exceeded dividends by over four and a half million dollars. Investments in marketable securities and fixed assets both increased by a large amount.

Russell Industries, Ltd. (14 years). The common dividend was reduced in 1931, but total dividends slightly exceeded profits. The company had surplus and investments to almost twenty times the amount of the reduction in dividends. In 1932 the common dividend was reduced almost to nothing and in 1933 the preference dividend was reduced; in both years the dividends slightly exceeded profits. For several years both investments and bank loans (of about a hundred thousand dollars) appeared on the balance sheet. The profits for the whole period exceeded dividends by almost one and a quarter million dollars.

The Steel Co. of Canada, Ltd. (14 years). Dividends exceeded profits in 1931, 1932, and 1933; the common dividend was reduced in 1933, although a large new purchase of marketable securities was made. Profits for the whole period exceeded dividends by thirteen and a half million dollars. Bonds of five and a quarter million dollars were paid off and fixed assets were heavily increased.

B. Seven of the companies examined paid dividends in excess of profits; the periods covered are 14 years for four companies and 13 years for three companies, ending with 1940.

(Thousands of dollars)

Net Profits 7,291; Dividends 23,677; Excess 16,386. The totals are not as significant as those for companies under paragraph A because there is much greater variation between individual companies.

Dominion Bridge Co., Ltd. (14 years). This company narrowly escapes appearing under paragraph A, for dividends exceeded profits for the whole period by only half a million dollars, total dividends being over twelve and a half million. Profits fell heavily after 1931 and did not recover their previous level. Dividends were reduced in 1931, twice in 1932 and in 1935, since when they have remained steady. Dividends exceeded profits in eight out of the fourteen years. Over nine million dollars of new capital was issued from 1928 to 1930.

General Steel Wares, Ltd. (13 years). Preference dividends were maintained, in spite of losses in 1930, and for one quarter of 1931, at which time accumulated surplus was used up and bank loans had appeared. After four years of losses and four years of profits preference dividends were resumed in the middle of 1938 and continued. Dividends for the whole period exceeded net profits by almost a million dollars; in spite of this bonds were redeemed to the extent of about two and a half million dollars. Inventories and accounts receivable were also reduced.

Hamilton Bridge Co., Ltd. (13 years). New capital of eight hundred thousand dollars was issued in 1929. Dividends were continued in 1931 and exceeded profits; preference dividends were paid in 1932 in spite of a loss. During a period of losses investments were sold and funds borrowed from the bank, and a capital reorganization took place in 1939 to eliminate the preference shares. Dividends for the whole period exceeded profits by one hundred thousand dollars, apart from the amount written off fixed assets at the time of reorganization.

Canadian Locomotive Co., Ltd. (14 years). Preference dividends were paid in 1928 and 1929 in spite of losses. In 1932 the company defaulted on its bond issue, disposed of large investments, paid off a large bank loan, and reorganized its capital. The net loss for the whole period was nearly half a million dollars and three hundred thousand dollars were paid in dividends. The company reported the remarkable achievement of operating without profit or loss in 1936 and 1937.

Canadian Vickers, Ltd. (13 years). Dividends ceased in 1930, when a loss was made, and a small amount of new capital was issued. The net loss for the whole period was over a million dollars and dividends of one hundred and eighty thousand dollars were paid during 1928-9.

Massey-Harris Co., Ltd. (14 years). New capital of fourteen and a half million dollars was issued in 1929. In spite of a loss of two million dollars in 1930 preference and common dividends of the same amount were paid, and a heavy bank loan was incurred. The sinking fund on bonds fell into arrears early in 1932; a refunding issue was made in 1939. The net loss for the whole period was nearly six million dollars, and dividends in the first four years amounted to six million dollars.

Cockshutt Plows Co., Ltd. (14 years). Dividends in excess of profits were paid in 1930, during which year funds were borrowed; in 1931 a reduced dividend was paid for the first half of the year and a loss was made. The company had no bond issue. The net profit for the whole period was two hundred thousand dollars; dividends paid during 1928-31 amounted to one million dollars.

DISTILLING AND BREWING INDUSTRIES

A. Six of the companies examined made profits in excess of dividends paid; the periods covered are 14 years for three companies and 13 years for three companies, ending with 1940.

(Thousands of dollars)

Profits 143,641; Dividends 72,857; Retained 70,784.

Distillers Corporation-Seagrams, Ltd. (13 years). A fall in profits in 1932 resulted in a large reduction in dividends; the company had little ready cash on hand. Profits fell again in 1933 and no dividends were paid in the period 1933-6. New capital was issued in 1934, large profits were made in 1935 and 1936, and "special loans" were also increased; during this period heavy expansion of inventories and of fixed assets took place. A further large capital issue (preference shares) was made in 1937 and there was a further expansion of inventories. Dividends on preference shares were paid in 1937 and on common shares from 1938. Total profits for the whole period were over fifty-two million dollars and dividends of sixteen million were paid; profits of thirty-six and a half million were retained and new capital of twenty million was issued.

Hiram Walker—Gooderham & Worts, Ltd. (13 years). Dividends in excess of profits were paid in 1931. In 1932 the capital was reorganized by the issue of preference and common shares in exchange for the old common shares, and preference dividends have been paid regularly. A small common dividend was paid in 1932 but none in 1933; in both years dividends exceeded profits. Dominion bonds were sold but the proceeds were not used to maintain dividends but to expand inventories and fixed assets and to reduce preference capital. Funds were borrowed from the bank to finance the expanding operations in 1934 in which year large profits began again, a large proportion being retained. A bond issue was made in 1936, and a further issue was made in 1938. Part of the first issue was redeemed in 1937 and new common shares issued; the information available suggests that this may have been in part a conversion. New preference shares were issued in 1939. Profits for the whole period were forty-six million dollars, and a

little over half of this amount was paid in dividends. Expansion was financed by profits retained of nearly twenty-three million dollars, bonds of a net amount of eleven and a half million, and shares of a net amount of three million.

Canadian Industrial Alcohol Co., Ltd. (14 years). Profits fell in 1930; dividends were reduced and funds were borrowed from the bank. Losses were made for four years (1931-4) and small annual profits were then made. New capital was issued in 1928 (two million dollars). From 1931 to 1937 many adjustments were made in the surplus account and accumulated operating losses and capital losses totalling nine million dollars were written off to capital. Net operating profits for the whole period exceeded dividends by two million dollars.

The National Breweries, Ltd. (14 years). Profits exceeded dividends in every year. Profits for the whole period exceeded dividends by over four million dollars; the outstanding bonds were redeemed and outside investments were increased.

Associated Breweries of Canada, Ltd. (13 years). Profits exceeded dividends, and preference shares were redeemed, in every year; a little new common share capital was issued in 1929, 1933, and 1938. Profits for the whole period exceeded dividends by over one and a half million dollars and net capital was reduced by half a million. Other changes are difficult to follow because the company's balance sheet is now consolidated but showed investments in subsidiaries as a single item in the early years.

Brewers and Distillers of Vancouver, Ltd. (14 years). Although good profits were earned in 1930, dividends ceased, the company having borrowed from the bank to expand inventories and accounts receivable; in 1933 bank loans having been paid off and inventories and accounts receivable reduced, a dividend was paid in excess of profits. This was an isolated dividend in the middle of seven years.

Dividends were started again in 1937, increased to exceed profits slightly in 1938, reduced in 1939 and remained constant in 1940, again slightly in excess of profits. Profits for the whole period exceeded dividends by three million dollars and one and three quarter million new share capital was issued in 1928.

B. One of the companies examined paid dividends in excess of the net profits.

Canadian Breweries, Ltd. (10 years). The company was formed in 1930 and paid preference dividends for three quarters. Losses were made in the four years 1931-4; in the last of these years a capital reorganization eliminated arrears of preference dividends. Preference dividends were paid in 1934 in spite of a loss, and they exceeded profits for the next two years. Since 1937 profits have exceeded dividends each year. Net profits for the whole period were one million dollars and dividends two million. Changes have been made in the capital and in the bonds outstanding every year, with no marked general trend.

OIL INDUSTRIES

A. Five of the companies examined made profits in excess of dividends paid; the periods covered are 14 years for one company, 12 years for one company, 11 years for two companies, and 10 years for one company.

(Thousands of dollars)

Profits 57,374; Dividends 40,252; Retained 17,122.

One of the companies paid dividends in excess of profits in three years, one company in two years and one company in one year. New capital of seven and a half million dollars was issued, and some old capital was redeemed.

B. One of the companies examined paid dividends in excess of profits.

Imperial Oil Ltd. (12 years). In 1930 and for the five years 1935-9 dividends exceeded profits by large amounts.

Investments in marketable securities and subsidiary companies, and fixed assets were reduced. Dividends exceeded profits for the whole period by nine million dollars. New capital of over seven and a half million dollars was issued 1929-35.

TEXTILE INDUSTRIES

A. Eleven of the companies examined (14 years for eight and 13 years for three) made profits in excess of dividends.

(Thousands of dollars)

Profits 50,957; Dividends 41,672; Retained 9,285.

One company paid dividends in excess of the year's profits seven times, one six times, one four times, two three times, four twice and one once; only one company made no demands on surplus for its dividends at any time. Over six and three quarter million dollars of new capital was issued, over five million of it in 1928-9; and about one and a half million dollars of shares were redeemed.

B. Two of the companies examined (14 years for one and 12 years for one) made net losses for the period and paid small dividends; one company in three years and the other in one year.

(Thousands of dollars)

Losses 2,139; Dividends 213.

C. Four of the companies examined (all for 14 years) paid out dividends greater than the profits made during the period.

(Thousands of dollars)

Profits 7,880; Dividends 9,955; Excess 2,075.

One company maintained common dividends for three years and preference dividends for six years beyond profits earned, and in spite of losses in three years. Another company which made profits every year paid dividends in excess of profits eight times. Of the other two companies, one

ceased dividends immediately after making a loss in 1930 and has not resumed them, and the other reduced its dividends three times and finally ceased paying.

Miscellaneous Industries

Ten companies were examined (14 years for five, 13 years for two, 12 years for two and 11 years for one) all of which earned profits in excess of dividends.

(Thousands of dollars)

Profits 572,627; Dividends 411,924; Retained 160,703.

Five of the companies made profits every year, two made very small losses in one year and two made losses in two years. Dividends requiring the use of surplus were paid once by two companies, twice by five, three times by one and six times by one; one company never paid dividends in excess of the year's profits. Most of the companies whose profits fell off about 1930 reduced their dividends very quickly but two companies did not, both of them having large surpluses. Three companies redeemed shares to the amount of over nine million dollars and two companies made capital issues totalling fourteen million.

APPENDIX E

Notes on Depreciation[1]

"A diligent search of the literature of accounting discloses an astonishing lack of discussion of the nature of income. One could hardly expect that the profession which, above all things, is most constantly engaged in the statistical treatment of income should have found almost nothing to say about the nature of the thing they measure so carefully."[2] On the other hand, the literature of economics discloses an amazing wealth of discussion of the nature of income, but contributes little to aid the business man in calculating individual income. Accountants show no more unanimity as to the nature of depreciation than do economists on the nature of income. Economists are usually concerned with the national income, whereas accountants are concerned with the profits of individual business; an accountant can obtain little help from an economist, and would be bewildered by the argument of, for instance, Pigou in his *Economics of Welfare* (Chap. 4). "In practical matters theoretical completeness may be purchased at too great a cost."[3]

The measurement of income or of profit involves both economist and accountant in a discussion of the maintenance of capital. "The value of the capital already invested in improving land or erecting a building; in making a railway or a machine is the aggregate discounted value of its estimated future net earnings."[4] The business man would find it difficult to believe that having had half his factory destroyed by an earthquake, his capital was kept intact by a halving of the rate of interest, or that a plant operated con-

[1] Reprinted from *The Commerce Journal* (University of Toronto), March, 1940.
[2] J. B. Canning: *The Economics of Accountancy* (New York, 1929), p. 93.
[3] Alfred Marshall: *Principles of Economics*, p. 76.
[4] *Ibid.*, p. 593.

sistently at a slight loss had no capital value at all. "The customary point of view of the business man is that which is most convenient for the economist to adopt when discussing the production of goods for a market, and the causes which govern their exchange value."[5]

What does the accountant mean by the maintenance of capital? Except on the sale of a business, the view that capital value is dependent on earning power is advanced seldom (e.g., in the hearings of the Royal Commission on the Textile Industry, in justification of the setting up of a goodwill account). The view is sometimes advanced that the annual charge for depreciation should provide for the replacement of assets. "In order to maintain capital intact, the price of the product must *in the long run* be sufficiently high to provide the sums of money required for renewals . . . In order to find what can be distributed as dividends at the end of the financial period, some charge has to be made on account of the capital consumption which has taken place during the period. These charges have to be sufficient to enable the company to replace the equipment when it wears out."[6] The same view appears to be stated in a rather confused way by Dicksee.[7] In the absence of inventions and improvements, this view might be satisfactory, but it takes no account of the scrapping of obsolete machines and complete changes in methods of production, when no recognizable replacement takes place. Further, this view would bring grave complications in a period of changing prices.

Another view, which is the one held by many modern accountants, is that the money value of capital must be kept intact. ". . . he prepares an account between the undertaking and its proprietors of the money capital adventured by

[5] *Ibid.*, p. 75.

[6] R. F. Fowler: *The Depreciation of Capital Analytically Considered* (London, 1934) p. 4.

[7] L. R. Dicksee: *Depreciation, Reserves, and Reserve Funds* (London, 1912), p. 2.

them."[8] "By recording depreciation in each financial period, the accountant endeavours to show the cost of the loss of life in a period against the earnings of that period."[9] "There is also a very common tendency—from which even accountants are not exempt—to confuse depreciation accounting and the financing of replacements.... As a matter of fact depreciation represents the extreme example of prepayment."[10] "Depreciation is not designed to adjust an asset to value, but is merely the cost of that portion of the total serviceability of the asset which—according to the best estimates available—has been used up to date."[11] "No doubt the business man, so far as he has given thought to the significance of his operating income concept, thinks of it as the measure of resources which from period to period he can withdraw from the enterprise while maintaining intact his original monetary investment. And the accountant's procedure is undoubtedly *intended* to yield such a measure."[12]

This last quotation is, perhaps, the most satisfactory. The Dominion Companies Act states (Sect. 83) that no dividend shall be paid which impairs the capital, and defines capital (Sect. 12) in a way which suggests agreement with the above quotation. The Ontario Companies Act states (Sect. 97) that no dividend shall be paid which diminishes the capital, and leaves it at that. The economist may well ask what is the significance of this concept of the maintenance of capital. The business man can probably reply only that it is conventional, that he is used to it, and that he has acquired an ability to make judgments with its aid; but he would find difficulty in demonstrating that his judgments were sounder as a result.

[8] S. W. Rowland: "Some Modern Difficulties in the Measurement of Profit" (*Some Modern Business Problems*, ed. by A. Plant, London, 1937, p. 257).

[9] W. S. Ferguson and F. R. Crocombe: *Elements of Accounting* (Toronto, 1936), p. 50.

[10] W. A. Paton: *Essentials of Accounting* (New York, 1938), p. 539.

[11] R. G. H. Smails: *Auditing* (Toronto, 1933), p. 118.

[12] R. G. H. Smails: "Economic and Accounting Concepts" (*Canadian Journal of Economics and Political Science*, Aug., 1937, p. 451).

"If the accountant is to allow for depreciation, it is difficult to see how his present method can be improved upon."[18] This refers to his theoretical method: in practice the widest departure from it is common in the accounts of a multitude of public companies, and no information is given in these accounts to show the extent of the deviation. Yet these accounts are the ones on which many business men base their judgments, and the ones which pass unchallenged by the financial writers in the press. They are also the only accounts available for such economists as try to put their technique to practical uses, unless they are given access to the books of the companies concerned. "Scientific accountancy has now been developing for some fifty years, but I cannot trace that it has yet made a single substantial contribution to economic science over its own field of the analysis of the results of industry, although it has practically a monopoly grip of the required data."[14]

Business men and accountants do not always put their theories into practice, nor do they all agree upon theory. An editorial article in the *Accountant*[15] states that, although a charge for depreciation is essential in arriving at net profit, charges for obsolescence should be considered as appropriations of profit. This is similar to the position taken by Pigou in the fourth edition of *Economics of Welfare*,[16] which has been effectively attacked by von Hayek,[17] and is not commonly held by accountants.

Why all this concern with the maintenance of capital? From the national point of view the true determination of income is of importance for taxation purposes and may some time be important in dealing with the trade cycle and the

[18] *Ibid.*, p. 452.

[14] Sir Josiah Stamp: *Studies in Current Problems in Finance and Government* (London, 1924). p. 16.

[15] Sept., 1937, p. 362.

[16] Chap. IV.

[17] F. A. von Hayek: "The Maintenance of Capital" (*Economica*, vol. II, Aug., 1935, p. 247).

standard of living. The vast array of published accounts of companies is, however, apparently almost useless in calculating the national income. "The characteristics of accounting practice—conservatism, inconsistency, variability from one concern to another (as in the treatment of intangibles, depreciation and maintenance) . . . mould the accounting figures into shapes not altogether fitted for our purpose."[18]

From the point of view of the individual company, the maintenance of capital is important for three classes of people: the management, the bondholders and other creditors, and the shareholders. No great difficulties would arise if we operated in a stationary state, but, in the violently fluctuating state we know, the difficulties are many and varied.

The management of a company may be so concerned to maintain the capital not only *of* the company but also *in* the company, that depreciation reserves will be invested in the expansion or maintenance of a declining industry or of a company heading for bankruptcy; and the mobility of capital in general will be reduced. An engineering company writes: "Money set aside to cover depreciation should be spent at once for new machines because . . . money invested in modern tools earns more than when invested in securities."[19] "The officers . . . are also inclined to expand the business persistently for the sake of personal aggrandizement and to secure higher salaries."[20]

The creditors of a company derive security from the maintenance of capital, and, since their claim on the company is in the terms of money, they are satisfied with the maintenance of money capital. The preference shareholders

[18] S. Fabricant: *Income and Wealth* (National Bureau of Economic Research), p. 141.

[19] P. T. Bauer and P. R. Marrack: "Depreciation and Interest" (*Economic Journal*, vol. XLIX. June, 1939, p. 243).

[20] B. Graham and D. L. Dodd: *Security Analysis* (New York, 1934), p. 330.

may have a similar interest on the winding up of a company, but companies seldom wind up voluntarily and the question hardly arises in bankruptcy.

Shareholders in general are interested in the maintenance of capital because they like to know whether they are living within their means, and because future income depends upon the continuing capital. ". . . the persons who draw an income from capital, want to avoid using up unintentionally parts of the source of this income, which must be preserved if income is to be kept at the present level."[21] Even if they could be sure that the policy of companies in fact maintained the money capital, however (and even if they knew what this meant), this would not secure the steadiness of "real" income, which is what most concerns shareholders as individuals.

The general approbation of the creation of reserves for depreciation, and the almost general approbation by business men of reserves deliberately in excess of requirements, is difficult to understand. The *Economist* writes: "Depreciation allowances are all the more necessary in a boom period, because there is always the practical certainty that the boom will decline more or less suddenly and will leave overvalued stock on hand."[22] "Now why the financial community should acquiesce in a condition of things in which a balance sheet can be almost anything, I cannot imagine."[23] But even if meticulously accurate practice of the accountant's technique could be imposed on all companies, the real meaning of a balance sheet would still be hard to explain.

Some of the effects of the creation of reserves for depreciation are not generally understood, but the amounts charged in their creation are so large that much further study of them is obviously desirable. Charges for depreciation in

[21] von Hayek: "The Maintenance of Capital", p. 249.
[22] W. H. Lough: *Business Finance* (New York, 1917), p. 425.
[23] Stamp: *Current Problems in Finance and Government*, p. 15.

one year have been estimated at $4,634 million in U.S.A.,[24] and at £18.7 million in Great Britain.[25]

No well defined policy as to the investment of these funds can be discovered, and no analysis has been made of accounts to show the extent to which excessive cash balances and outside investments (which may also be held for equalization of dividends of course) can be set against these reserves, or to what extent they have been reinvested in the businesses creating them. The fact that the technique of accountants does not provide for the replacement of assets tends to make them indifferent as to the investment of the funds. Bankers seem to be so obsessed with the desirability of all types of reserves at all times that they tend to forget that an important decision is involved. The managers of companies make their decisions on grounds which vary enormously and which they do not discuss. And economists may tend to believe that these funds are held available to pay for replacements. "It may happen that a firm sets aside for depreciation more than it actually spends in maintenance . . . The amortization fund held against depreciation consists of assets of some kind (money or securities). . . . ."[26]

Many companies reinvest their depreciation reserves in their own business and thus automatically expand their operations. "The common procedure of conservative financing is to reinvest in the business that portion of the earnings which fairly represents the accrued depreciation during the year."[27] This expansion continues until "replacements" are needed, and, in a large company, until the fixed assets are on the average half worn out. To whatever extent the fixed assets are themselves expanded by this reinvestment, the same process continues with the new fixed assets so acquired.

[24] S. Fabricant: *Capital Consumption and Adjustment* (New York, 1938), p. 33.
[25] *Report of "Colwyn" Committee on National Debt and Taxation*, p. 20.
[26] R. F. Harrod: *The Trade Cycle* (Oxford, 1936), p. 62.
[27] E. E. Lincoln: *Applied Business Finance*, p. 729.

For instance, if fixed assets are depreciated at 10 per cent p.a. and half the depreciation funds are reinvested in fixed assets, the automatic increase in the amount of fixed assets in ten years will be over 62 per cent. If a company carefully plans an expansion by the issue of new share capital, the actual expansion will be greater than that planned because depreciation funds are kept within the business.

If a company has its fixed assets re-valued, and sets them up in its accounts at their appraised value, the whole scheme of providing for depreciation will be destroyed, and the analysis of accounts will be made correspondingly more difficult. An appraisal of this type often preludes the formation of a new company to take over the assets of the old; when this occurs a larger charge can be made for depreciation for income tax purposes, although no physical change has been made in the assets. This not only reduces the percentage of profit on the capital invested but reduces also the actual net profit reported for the whole of the remaining life of the assets, and this may have repercussions on labour.

When a company uses a cost accounting system for the purpose of tendering for a contract, appraisals and depreciation charges may have a wide effect, and when, in imperfect competition, such a company dominates a market sufficiently to enable it to fix prices, appraisals and depreciation charges may cause a rise in price. Further, the manipulation of depreciation charges may affect the relative positions of different classes of shareholders.

The Courts have not illuminated the concept of maintenance of capital,[28] in fact, their slightly different terminology has added some confusion, but decisions seem, in

[28] See W. A. Robson: "Legal Conceptions of Capital and Income" (*London Essays in Economics*, ed. by T. E. G. Gregory, London, 1927) and R. S. Edwards: "A Note on the Law Relating to Company Dividends" (*Economica*, vol. VI. May, 1939, pp. 170-90).

general, to follow business and accounting tradition. One point of interest is the question whether past losses of a company must be made good before dividends may be paid out of current earnings. Few cases have been tried, but if this attitude were unequivocally adopted by the Courts, the effect would be to enforce investment which might be ill-advised, and which might result in a new series of losses in the future.

APPENDIX F

Dominion Textile Company

Introduction

As a result of the closing of one of the mills of Dominion Textile Company in January, 1936, a Royal Commission on the Textile Industry was appointed; two years later, it submitted a report based on a comprehensive investigation into the condition and history of the industry. The facts recorded in this appendix are drawn from the report and the evidence. That this company, and the industry as a whole, had received the benefit of tariff protection was emphasized by the report, which also discussed the responsibilities of an industry towards the wage-earners and the community at large. The report provides illustrations of many of the points discussed earlier in this book.

The Syndicate

The consolidation of four textile companies into a new company, Dominion Textile Company, was planned in 1904 by a syndicate of sixteen men, of whom six were each directors of one of the four companies. Broadly, the plan was for an exchange of shares in the old company for shares and bonds in the new company, through the syndicate. The plan was discussed by the directors of each company and its acceptance was recommended by them to the shareholders. No evidence was produced to show that any of the directors disclosed to their fellow-directors or to the shareholders their personal interest in the syndicate; in fact, the evidence produced suggests the contrary.

1. *Dominion Cotton Mills.* At a meeting of the directors, the president put forward "an offer made on behalf of a syndicate composed of Messrs. David Yuile, John P. Black,

Charles Gordon, and several other gentlemen"; he was himself one of the "other gentlemen". In answer to a question at a meeting of shareholders, the president denied that any contract had been made "between the directors of the Dominion Cotton Company and other concerns, for instance especially with the Dominion Textile Co., in regard to the common stock, preferred stock or bonds of this company, or of bonds, preferred stock or common stock of the Dominion Textile Co."

2. *Merchants Cotton Company.* The vice-president was a member of the syndicate, and at a shareholders' meeting he said that he thought acceptance of the offer was in the interests of all the shareholders. Asked if he had any advantage over and above the ordinary shareholders in selling his shares, he replied "Not the slightest . . . I have just the same as any other shareholder, exactly the same thing."

3. *Montmorency Cotton Mills Co.* At a meeting of the directors, the president stated that "he had been interviewed by the representatives of a syndicate"; he himself was a member of the syndicate. A large majority of the shareholders accepted the offer before a general meeting was held.

4. *Colonial Bleaching and Printing Co.* No difficulty was experienced in persuading a large majority of the shareholders to accept the offer.

TERMS OF EXCHANGE

The syndicate contracted with Dominion Textile Company:

(1) to subscribe in cash at par for 5,000 7% Preferred Shares of $100 each, and (2) to be allotted 50,000 Common Shares of $100 each, and sufficient 6% Bonds and 7% Preferred Shares to enable them to carry out their offer to the shareholders of the old companies; and to hand to the company $500,000 in cash, and the shares in the old companies which they acquired through acceptance of their

offer. Although counsel for the company maintained that the second of the above items could not be subdivided, it is evident that the syndicate received common shares with a nominal value of $5,000,000 for a cash payment of $500,000. The syndicate was able to acquire 24,467 out of 30,336 shares in Dominion Cotton Mills; 14,118 out of 15,000 shares in Merchants Cotton Company; 9,693 out of 10,000 shares in Montmorency Cotton Mills Company; and 2,368 out of 3,000 shares in Colonial Bleaching and Printing Company. In return for these shares, it received $2,759,000 of bonds, and 12,222 preferred shares of Dominion Textile Company, which it distributed in accordance with the plan to the shareholders who had accepted the offer.

The syndicate made its offers, through a trust company, to the individual shareholders of each company, and not to the companies. Many of the shareholders accepted the offers before the companies held general meetings, so that when those meetings were held their shares had been surrendered to the syndicate, and the only shareholders, other than directors, attending the meetings were those who had not accepted the offer made to them. Dominion Cotton Mills was much the largest of the four companies, and Merchants Cotton Company was easily the second largest, and the offers made to the shareholders of these two companies appear to have been less generous than those made to the smaller companies. The counsel appearing before the Commission to represent Dominion Textile Company stated that "The syndicate was fortunate enough to acquire from the shareholders of the old companies at less than their real values the shares which they turned over with other assets to the company."

1. *Dominion Cotton Mills.* The offer to shareholders of this Company amounted to fifty cents on the dollar of the nominal value of the shares, half to be paid in bonds and half in preferred shares; and showed a book loss to share-

holders of over $2,000,000. A shareholder complained "that directors not representing over six hundred shares would recommend, without consulting the shareholders whatever, to sell their stock at fifty cents on the dollar, when twelve months before that they showed us in good faith, I presume, that there was to our credit 125 cents on the dollar . . . we have not looked at that with as much pleasure as the Chairman has." Another shareholder, referring to the fact that the secretary had reported profits for the previous year equal to 6½% on the shares, and that the president had recommended acceptance of the offer of 50 cents on the dollar, said: "Now, Mr. Chairman, I know I am not dealing with the Dominion Textile Company here, but I am dealing with our guardians, with the people we put in trust to keep our stock right, and I ask this question: is it fair to the shareholders of the Dominion Cotton Mills Co. to treat us in that way? It is generally believed that the syndicate will get a very large proportion of stock for their $500,000. It is generally believed so. If so . . . why do you as directors try to get us shareholders into such a trap?"

2. *Merchants Cotton Company.* The offer to the shareholders of this company amounted to eighty-five cents in the dollar of the nominal value of the shares, two-thirds to be paid in bonds and one-third in preferred shares; and showed a book loss to shareholders of over $600,000. The company had shown profits of $54,000 and $105,000, or 3% and 6% on the nominal capital, in the last two years.

3. *Other Companies.* The offers to the shareholders of the two other companies showed book profits of $207,000 and $190,000, and the offers were quickly accepted by all the shareholders.

Dissident Shareholders

A number of the shareholders of Dominion Cotton Mills held out for a long time. The company, with Dom-

inion Textile Company owning a large majority of the shares, leased the whole of its undertaking to the new company at a rent which allowed it to pay an annual 4% dividend. This continued until 1917, when all the outstanding shares were acquired by Dominion Textile Company.

Investment in New Company

The syndicate received common shares with a nominal value of $5,000,000 in return for $500,000 in cash; this meant that $4,500,000 was paid for goodwill. Some years afterwards, the company transferred over $2,000,000 of this to various asset accounts on the grounds that the assets had been worth this additional amount when they were acquired. The Commission refused to recognize this and maintained that the $4,500,000 "did not represent a real investment."

The bond interest and preference dividends were paid regularly, and after two years dividends were paid on the common shares at 5%, then at 6%, and later at 7%. The counsel for the company maintained that these high earnings (on watered stock) proved that the payment of $4,500,000 to members of the syndicate was justified; and held that these earnings resulted from the benefit of unified control, reduction in overhead, reduction in competition, and the services of the syndicate in effecting the consolidation. The chairman of the company, however, reported to the shareholders in 1907 ". . . these have been very prosperous times for the cotton business . . . we must not expect that times like the present in the cotton business are going to continue forever." They continued for a long time, and were shared by other textile companies, because of the rapid agricultural development of Canada and the maintenance of favourable tariffs.

Although counsel for the company stated that the protection afforded to the textile industry "is not sufficient to

assure to that industry a fair yield on its investment having in view the risks involved", the company retained profits to expand operations to the amount of over $5,000,000 within thirty years. At the time of the Royal Commission, the common shares which were obtained for $500,000 cash plus "goodwill" had brought an average annual return of 98% on the cash invested.

NOTES ON LATER HISTORY

In 1908, the company earned 32.4% on its common stock equity, or 5.4% including goodwill in the equity. Wage reductions were reported and associated with the tariff. In 1921, a bonus of $35,000 was paid to the president, and smaller bonuses to other salaried staff, for services from 1918-21. These bonuses were passed at a directors' meeting and were charged in the accounts before arriving at "Manufacturing Profit". No mention was made of them at the general meeting, but the president reported: "We have not materially reduced our wages yet." In 1924 the assets were written up by $7,500,000 after an appraisal.

In 1928, the president complained of the tariff rates set by the Tariff Advisory Board; the ratio of earnings to investment capital was 10.6% in 1926, 15.45% in 1927 and 9.66% in 1928, according to the company's expert accountant before the Royal Commission. In spite of the lowering of what the president thought was an inadequate tariff the directors continued to reinvest profits, and recommended new common share issues of $3,375,000 to the public. In 1933, the company showed a loss on operations for the first time, but evidence was available before the commission that the directors could have shown a profit, had they so wished, without departing from their traditional accounting procedure. The report of the directors referred to the baleful effects on the company of the Ottawa Agreements. The next year showed profits again; the directors drew

attention to the fact that the company had paid an average of 4.8% per annum on the average net worth of the company since its inception—but the average net worth used in their calculations included both the $4,500,000 of goodwill and the $7,500,000 write-up of assets after appraisal in 1924. The evidence before the Commission suggested that companies which had injected water into their capital expected adjustments in the tariff to change it into wine.

APPENDIX G

Reorganization of Winnipeg Electric Company

Prologue

In November, 1935, the Winnipeg Electric Company put before its shareholders a plan of reorganization and consolidation drawn up by protective committees representing bond and shareholders of the company and its subsidiaries. The group of companies had been in financial difficulties for some time. The parent company was operating the tramways of the city under what had become an onerous franchise; it had tried to sell this part of its undertaking to the city, and had then tried to obtain relief from the terms of the franchise by promoting a Bill in the Manitoba Legislature, without success. The Insull group had acquired an interest in the company, and was represented on the board. Preference dividends had been paid until 1931, and dividends had been paid on the common shares from 1925 to 1930. The parent company had guaranteed the bonds of all its subsidiaries, and failed to redeem nearly $3,000,000. of its own bonds maturing early in 1935.

The Northwestern Power Company was formed in 1928, and failed to meet its bond interest in 1931; the Winnipeg, Selkirk and Lake Winnipeg Railway defaulted on payments of both interest and capital in 1933. The parent company had been unable to fulfil its guarantee. The Manitoba Power Company paid dividends from 1928 to 1930, but the other subsidiaries had paid no dividends.

Terms of Reorganization

The reorganization was accepted by the various bondholders and shareholders of all the companies, and received the approval of the Court in February 1936.

Winnipeg Electric Company. The capital structure of

the parent company before the reorganization is shown below; the bonds are stated at the net amount outstanding in the hands of the public.

Bonds

5% Gold Bonds, due 1935 (in default	$2,900,000.
6% Bonds, due 1954	7,000,000.
5% Mortgage Stock, due 1954	4,300,000.

Shares

7% Cumulative Preferred Shares	$5,000,000.
244,772 Common Shares of no-par value	13,900,000.

A Special Bank Loan of $1,250,000 had already been arranged.

The capital structure after the reorganization and consolidation is shown below; the subsidiaries no longer had any bonds or shares outstanding.

Bonds

4½% First Mortgage Bonds (sinking Fund from 1941)	$3,500,000.
30-Year General Mortgage Bonds, Series A	$29,275,500.
(4% to 1942; 5% afterwards)	
30-Year General Mortgage Bonds, Series B	$ 6,000,000.

(4% to 1942; 5% afterwards. Interest payable only out of "Available Income" for the first twelve years.)

Shares

Non-cumulative Preferred Shares	$50,000.
(4% to 1942; 5% afterwards)	
281,712 Class A Common Shares of No-par Value	
283,581 Class B Common Shares of No-par Value	

Certificates

Contingent Certificates	$1,921,234.

(Non-interest bearing; no dividends to be paid until these certificates redeemed).

The management was placed in the hands of a board of twelve directors, half of whom were to be elected by the bondholders and half by the Preferred and Class B shareholders, for the first seven years. At the end of seven years Class A shareholders were to have equal rights with Class B. All the new bonds were in Canadian currency only, whereas the old bond, had optional currency rights.

The First Mortgage Bonds were issued to provide for the payment in cash of the 5% Gold Bonds of the parent company, already in default, and also to provide funds to carry out the scheme and to improve the working capital position. The rate of interest on this bond issue was left to be determined by market conditions, subject to approval by a committee, and the issue was eventually made at 4½%.

The 6% Bonds of the Winnipeg Electric were replaced by an equal number of General Mortgage Bonds, Series A, together with an issue of $70 Contingent Certificates and nine Class A Common Shares for each $1,000 of bonds. The 5% Mortgage Stock received the same treatment except for an issue of only seven Class A Common Shares in place of nine. The arrears of interest of both classes of old bonds were paid in cash.

The 7% Preferred Shares were replaced by an equal number of new Preferred Shares together with one Class B Common Share for every two Preferred. The Common Shares were converted into Class B Common Shares.

Manitoba Power Company. The funded debt of this company consisted of $11,521,700 5½% Bonds, due 1951-2, on which interest had been paid up to date. These bonds were replaced by an equal number of new Winnipeg Electric General Mortgage Bonds, Series A, together with $70 Contingent Certificates and nine Class A Common Shares for each $1,000 of bonds. The shares of this company were almost all held by the parent company; the 8,000 shares (of no-par value) held by the public were converted into an equal number of Class B Common Shares.

Northwestern Power Company. The funded debt of this company consisted of $10,000,000 6% Bonds, due 1960, on which interest was in arrears for three years. The arrears of interest were cancelled, and for each $1,000 of bonds the holders received $400 new Winnipeg Electric General Mortgage Bonds, Series A and $600 Series B, together with $28 Contingent Certificates and eight Class A Common Shares. The company had issued $44,475 of Scrip Certificates in lieu of premiums on U.S.A. currency at the time of the last interest payment, and these certificates were redeemed at 20% of face value in cash. Almost 90% of the shares of the company were held by the parent company; the 28,000 shares (of no-par value) in the hands of public were converted into Class B Common Shares, one new for every five old shares.

Winnipeg, Selkirk and Lake Winnipeg Rly. The bonds of this company, in default as to interest and principal for over a year, were mostly held as collateral security for bonds of the parent company, but $44,500 5% Bonds were held by the public. These bonds were replaced by an equal number of new Winnipeg Electric General Mortgage Bonds, Series A, together with $70 Contingent Certificates and eight Class A Common Shares; the arrears of interest on the old bonds were paid in cash. None of the company's shares were held by the public. The legal existence of this company was preserved to protect franchises and rights which it held.

Suburban Rapid Transit Co. The funded debt of this company consisted of $500,000 5% Bonds, due 1938, on which interest had been paid up to the previous August. The interest for five months was paid in cash, and the bonds were replaced by new Winnipeg Electric General Mortgage Bonds, Series A, together with $70 Contingent Certificates and eight Class A Common Shares for every $1,000 of bonds.

SUBSEQUENT HISTORY

Instalments were paid on the Special Bank Loan regularly as required until 1939, when the remaining balance was paid in full. Redemption of the Contingent Certificates began in 1937; the payments were irregular, but redemption was completed by two large payments in 1943 and 1944. The 4½% First Mortgage Bonds were refunded at 3½% in 1940, and redemption of General Mortgage Bonds, Series A, was started on a small scale in 1941. Dividends have been paid regularly on the 5% Preferred Shares since 1944. In 1946 the whole of the outstanding bonds were redeemed and a smaller issue of new bonds was made at lower interest rates; and a first dividend was paid on the Common Shares.

When the right of the bondholders to elect half of the board of directors expired, four of these six directors were retained. The franchise negotiations between the company and the city have not yet brought results.

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INDEX

(The Appendices are not indexed)

A

Accounts payable, 37, 97
Accounts receivable
  assignment of, 40
  management of funds, 37, 97
After-acquired property
  40, 44, 49, 53
Arbitrage, 88
Assets
  depreciation of, 94, 103, 217
  mortgage of, 40
  overpayment for, 34
  replacement of, 105
  shares, consideration for, 21, 26
  types of, 94

B

Bankruptcy
  Act, 144, 150, 151, 153
  acts of, 154
Banks
  balances with, 99
  brokers' loans, 72-4, 81, 92
  capital market, 65, 67
  central, 65, 67
  discounting bills, 40, 98
  false liquidity of, 38, 100
  foreign trade, 98
  liquidation of, 156
  loans, 38-43, 96, 98, 100
  margin, buying on, 84
  Section 88 of Act, 38, 40
  security, limitation on, 38
  Trust companies, relations with, 129
Board of Railway Commissioners, 138
Bond dealers, 70-6
Bondholders
  effect of inflation on, 58
  power to bind minority, 50, 147, 149, 150
  protective committee for, 146
  relation to company and trustee, 42
  reorganization and, 50, 145
Bonds
  current liabilities and, 48, 95
  fixed charges, burden of, 57
  government, 43, 50, 52, 70
  market for, 71
  methods of issue, 70
  mining companies and, 79
  reasons for issuing, 41, 70
  redemption of, 45, 46, 47, 48, 52, 54, 57, 59, 108
  refunding to reduce charges, 47, 48, 50
  regulation of issues of, 76
  sanctions, 49
  security for, 44, 49, 145
  trust deed for, *see* Trust Deed,
  types of, 50-4
Bonus shares, 35
Borrowing (Chap. iv)
Branches, control of funds of, 102
Budgeting, 106
By-laws, 14, 59
By-products, 119

C

Capital (Chap. iii)
  authorized and issued, 20
  reduction of, 59
  reorganization of, 60, 145
  watered, 33, 36, 56, 58, 66
Capital market (Chap. vi)
  financial institutions, 66
  influence on structure, 56

Capital structure
bonds *vs* shares, 57
changes in, 59, 146
examples of, 61-4
influence of market on, 56
simplification of, 31
Cartels, 142
Cash, in relation to working capital, 95
Charter, 10, 11
Combination (Chap. x)
control of, 140
formal agreements, 126
informal agreements, 125
limitations on, 128
management, power from, 178
marginal costs and, 133
motives for, 132
objections to, 133
regulation of, 136, 140
unfair practices, 143
watered stock, 35
Combines Investigation Act, 136, 141, 143, 167
Commissions
companies, compared with, 167
form of business organization, 5
monopoly, control by, 138
Companies
Adam Smith and, 162
control of, 166
divorce of management and ownership, 134, 165
Dominion and Provincial, 5, 9
form of business organization, 4
impersonal relationships in, 5, 122, 160
incorporated by special acts, 5
limited liability in, 5, 80, 161, 164, 165
Mill, J. S. and, 163
opposition to, 164
origins of, 158, 160
private. *See* Private companies
reorganization of, 148
social purpose, fulfilment of, 166, 169, 177
Companies' Creditors Arrangement Act, 144, 148, 149, 151, 155
Companies Information Act, 77
Compromise, 151, 155, 156
Corporate personality, 4, 20, 159, 165, 167
Corporations. *See* Companies
Creditors
compromise with, 151, 155
protective committee, 147

D

Depreciation, 94, 103, 118
Directors
active and passive, 13
appointment of, 12, 173
dividends declared by, 22
duties of, 16, 18
functions of, 171
interlocking, 129
management and, 172
personality of, 13, 173
provisional, 10, 12
qualifications, 12
remuneration of, 174
speculation by, 16
trusteeship of, 172
Distributable surplus, from consideration received for N.P.V. shares, 31
in relation to dividends, 108
Dividends
arrears of, 22, 23, 60
date of record, 33
declaration of, 22
policy, 108
surplus and, 108
types of shares and, 22
Division of labour, 116
Double liability, bank shareholders and, 5, 156

E

Economists
  corporate form of business, 165
  expansion of business, 113
Escrow, 7, 79
Expansion
  depreciation and, 103
  estimate of funds for, 56
  horizontal and vertical, 111
  limits to, 115
  methods of, 115
  planned, 113, 116
  profits retained and, 37, 66, 109
  reasons for, 112
Extra-Provincial Companies Act, 9

F

Farm Improvement Loans Act, 38
Federal Trade Commission, 141, 143
Finance and Discount Companies, 68
Financial institutions, 66
Financial structure (Chap. v)
Fixed charges. *See* Overhead costs
Floating charge, 44, 49, 145
Formation of companies (Chap. ii)
Foreign trade financing, 98
Forms of business organization (Chap. i)
Fractional certificates, 150
Fraud, 27, 30, 31, 79, 87
Funds
  estimate of needs, 56
  management of (Chap. viii)
  scale of operations and, 121
  seasonal need for, 96
  sources of, 37, 66, 101
  working capital and, 95

G

General charge, 44, 49, 145
Government enterprises, 8, 138-40

H

Holding companies, 130

I

Incorporation, 5, 8, 10, 180
Industrial Development Bank, 39
Insurance companies
  capital market, 67
  shareholdings of, 171
Integration. *See* Expansion
Interest rates
  banks, 101
  effects on bondholders, 47, 48
  effects on capital market, 65
  speculation and, 85
Interlocking directors, 129, 173
Investment Trust Companies, 68

L

Letters patent, 10, 11
Liabilities
  types of, 95
Limited liability
  defined, 5
  development of, 161
  significance of, 165
  stock market needed for, 80
Limited partnership, 4
Liquidation (Chap. xi) *Also see* Winding-up
Liquidity
  banks and, 38
  stock exchange and, 80, 89
Loans
  Banks. *See* Bank loans
  Loan companies, 68
  short term, 38

M

Machinery, replacement of, 105
Management
  appointment, 18
  budgeting used by, 106
  corporate personality and, 159, 168
  directors and, 172
  dividend policy of, 110
  divorce from ownership, 134, 165
  economic and political power, 134, 177
  functions, 123
  impersonal, 160
  initiative of, 168
  interests of, 165
  motives for expansion, 113
  remuneration, 167, 174
  responsibility, 169
  scale of operations and, 122, 124
  shares, 14, 26, 149
Margin
  buying shares on, 84
  manipulation of prices, 87
  stock exchange functions and, 84, 92
Memorandum of agreement, 10
Mergers, 131, 226
Mill, J. S., 163
Mining
  companies, 77
  syndicates, 7, 78
Minority shareholders, protection of, 18, 61
Money market, 65
Monopoly (Chap. x)
  abuses, 134
  methods of control of, 137
  need for, 135
  regulation of, 136
  transportation and, 135
Mortgages
  assets, 40
  definition, 40
Municipal enterprise, 8

N

No-par shares, 27-31, 34, 36, 59, 73
Notes, promissory, 41

O

Optimum size, 124
Overhead costs
  effects of change in price level, 58
  fixed charges on bonds, 57
  scale of operations and, 118

P

Partnerships, 2, 164
Pre-emptive right, 73
Private companies contrasted with small companies, 167, 178
  contrasted with limited partnerships, 4
  form of business organization, 6
Professions, some cannot operate as companies, 6
Profits
  bond redemption and, 45
  dividend policy and, 46, 187
  expansion by retention of, 37, 66, 109, 115
  retention of, and bank loans, 101
  scale of operations and, 113
Promissory notes, 41
Promoters
  capital structure and, 32
  combination and, 132
  directors chosen by, 12
  encouraged by speculation, 91
  expansion and, 113
  mining companies and, 77
  protection of public against, 76
  watered stock and, 33
Prospectus
  commission on share issue, 72
  delivery to investors, 76-7
  filing of, 76

Protective committees, 146
Proxies, 15, 18, 130, 184
Public interest
in organization and control of companies, 19, 76, 79, 166
Public utilities, 58
Published accounts, form of control, 99, 167

R

Receiver and manager, 49, 153
Redemption. *See* Bonds and shares
Reorganization (Chap. xi)
Bankruptcy Act, under, 150
bondholders and, 50, 145
Companies Act, under, 148
Companies' Creditors Arrangement Act, under, 149, 155
dividend arrears and, 60
funds for, 56
methods of, 146
protective committees, 146
reasons for, 60, 145, 148
watered stock and, 55
Winding-up Act, under, 150
"Rights" to subscribe to shares, 73

S

Savings, new securities and, 74
Scale of operations (Chap. ix)
of companies compared with other businesses, 5, 165
power of management and, 178
profits and, 113
Securities Act
control of companies, 167
control of underwriters, 77
mining companies and, 79
stock exchange and, 89
Securities and Exchange Commission, 77, 174
Shareholders
control by, 17
liability of, 5
original, 10, 176
power to bind minorities, 18, 61
pre-emptive right, 73
present position of, 170
protection of, 7, 19, 27, 30
reorganization and protective committee, 146, 151
risks undertaken by, 176
Shares (Chap. iii)
application and allotment, 21
certificates, 20, 32
change in conditions, 60
exchange of, and monopoly, 130
issued for cash and other consideration, 21, 26, 30
method of issue, 72-3
mining companies in, 78
new funds and issue of, 69
no-par value, 27-31, 34, 36, 59, 73
pre-emptive right, 73
redemption of, 26, 57
regulation of issue, 76
types of, 21-7
warrants, 33
"Splits", 59
Short selling
defined, 85
functions of, 89, 92
manipulation of prices by, 87
Sinking fund, 46, 48
Smith, Adam
combination, 134
companies, 162
Sole proprietor, 1, 164
Source of funds. *See* Funds
Speculation
brokers' loans and, 92
buying on margin, 84
directors, by, 16
functioning of stock exchange and, 89-93
short selling, 85
State
control of companies by, 159, 166, 178

Stock market (Chap. vii)
arbitrage, 88
buying on margin, 84
curb market, 82
functions of, 80, 89
issue of mining shares through, 78
maintaining prices in, 73, 78
manipulation of prices, 81, 86-8
organization of, 81
pools, 87
regulation of, 81, 85, 89
short selling, 85-6
stop-loss orders, 86
unlisted shares, 82, 83
Stockholders
advice by, 74-6
bank loans to, 72-4, 82, 92
company may not act as, 6
maintenance of prices by, 73, 78
margin buying and, 84
mining companies and, 78
odd-lot specialists, 82
operating on own account, 81, 84, 86, 88, 90
origin of, 81
shares issued by, 72
watered stock and, 33
See also Stock market
Subsidiary companies
control of funds of, 103
method of expansion, 116
Succession duties, 2
Supplementary Letters Patent, 29, 59
Surplus. *See* Distributable surplus

T

Technology, scale of operations and, 119
Trade associations, enforcement of agreements by, 126
price information, 125
Trading on equity, 57, 58
Treasury Bills, 70
Trust companies
banks and, 129
business of, 68
capital market and, 68
receivers in bankruptcy, 68
trustees for bondholders, 42, 68
Trust deeds
purpose of, 42
receivership under, 153
reorganization and, 50, 145
terms of, 43
See also under Bonds
Trustees for bondholders
receiver appointed by, 49, 154
redemption of bonds, 47
relation to company and bondholders, 43
sanctions applied by, 49
See also Trust companies and Trust deeds
Trusts, 129

U

Underwriting, 73
See also Bond dealers
Unions, 117

V

Voluntary liquidation, 157
Voting rights, 14
Voting trusts, 15

W

Watered stock
definition of, 33-6
issued during booms, 58
reorganization and, 55
retention of profits and, 66
Winding-up
Act, 144, 150, 152, 156, 157
insolvent company, 156
preference shares in, 22
solvent company, 157
Working capital, 95