CHAPTER XIX

THE MORAL ASPECT OF STOCK WATERING

In the last chapter we saw that a monopoly has no right to gains in excess of the competitive rate of interest on its capital, except in so far as these have been derived from superior efficiency. Now superior efficiency is clearly present whenever the monopolistic concern obtains surplus gains by selling its product at competitive prices, or at the prices that would have prevailed under competition. Evidently the surplus in such a case is due to the greater productivity of the monopoly as compared with the average productivity of competitive concerns. When, however, the monopoly charges prices above the competitive level, its surplus gains cannot all be attributed to unusual efficiency. A part if not all of them are the result simply of the power to take; consequently they are immoral.

One of the means by which some monopolies have obtained unjust surplus gains is overcapitalization, or stock watering. This practice is rarely found in businesses that are subject to normal competition. So far as the consumer is concerned, a corporation that cannot fix prices arbitrarily has nothing to gain by inflating its capital. Unless it develops exceptional efficiency, it cannot hope to obtain more than the competitive rate of interest on its capital; if it does become exceptionally efficient, it can take the resulting surplus gains without arousing public resentment or criticism. In either case, it will have no sufficient reason to deceive the public by exaggerating the amount of its capital. When a competitive concern does water its stock, the object will be to defraud investors. If the scheme is successful the unjust surplus gains are taken by

one set of stockholders from another set of stockholders. Whenever anything of this sort occurs, the deceptive devices employed are so crude and obvious that they present no special problem for the moralist. Even as practiced by monopolies, stock watering raises no principle that has not been already discussed. It does, however, create some special difficulties in the matter of applying the moral principles involved. Consequently, it may with advantage be considered in a separate chapter.

The general definition of overcapitalization is capitalization in excess of the proper valuation of a business. What is the measure of proper valuation? According to many corporation directors, it is earning power. If a concern is able to get the prevailing rate of interest on a capitalization of ten million dollars, that is the proper capitalization for that concern, even though the money actually invested might not have exceeded five million dollars. In the opinion of most other persons, however, a company is overcapitalized when the face value of its securities is greater than the money put into the business plus the subsequent enhancement in the value of its land. "The money put into the business," means that which has been expended for labor, materials, land, equipment, and all other items and costs of organizing the concern, together with the sum that is necessary to cover the interest not obtained by the investors during the preparatory period before the business became productively operative. The increase in the value of the land after its acquisition by the company also deserves a place in the legitimate valuation, and may reasonably be represented by an appropriate amount of securities. Monopolistic corporations have as good a right, generally speaking, to profit by the "unearned increment" of land as competitive concerns.

Injurious Effects

Stock watering can become an instrument of unjust gains in two ways: first, through fraud inflicted upon some

of the investors; second, through the imposition of exorbitant prices upon the consumers. The former cannot occur so long as the process of inflation does not go beyond earning power; for in that case all stockholders, barring dishonest manipulation of the company's receipts, will obtain the normal rate of interest on their investment. If, however, stock is sold in excess of the earning power of the concern, those stockholders who fail to obtain the ordinary rate of interest on their money are unjustly treated in so far as they have been deceived. And those officers or other members of the corporation who have profited by the deception of and injury to these stockholders, are the recipients of unjust gains. Daniel Drew inflated the capitalization of the Erie Railroad from seventeen millions to seventy-eight millions within four years for the purpose of manipulating the stock market; owing to excessive issues of stock, the American Shipbuilding Company was thrown into bankruptcy to the great injury of all but one of its stockholders;[1] because they issued securities to buy subsidiary railway lines at exorbitant prices, and to provide extravagant commissions and discounts for bankers, the directors of the 'Frisco System forced it into a receivership, after having inflicted a net loss of four million dollars per year upon the stockholders.[2] Many other notable performances might be cited where stock watering, both in railroads and in industrial concerns, has defrauded investors of millions of dollars, and enabled a few powerful directors to reap corresponding enormous profits.

At first sight it would seem that stock watering is of little or no importance to the consumer. Since a monopolistic concern endeavors to fix its prices at the point that will yield the maximum net profit in any case, the amount of stock in existence would seem to be irrelevant to the problem. Nevertheless, the presence of a large quantity of

[1] Cf. Ripley, "Trusts, Pools, and Corporations," pp. 207-210.
[2] See Report of the Interstate Commerce Commission on these transactions.

fictitious capital whose owners are calling for dividends, sometimes constitutes a special force impelling the imposition of higher prices and charges. "It will happen at times that overcapitalization does at least cause a clinging to high prices. The managers of an overcapitalized monopoly may have to face the fact that great blocks of securities are outstanding, very likely issued by their predecessors, and now held by all sorts of investors. They are then loath to let go any slice of its profits. We have seen that often the monopoly principle of maximum net profit is not applied in its full sweep, especially in industries which are potentially subject to public control. Where abnormal returns on the original investment have been made, concessions to public opinion in the way of low rates and better facilities are more likely to come when capitalization has not been inflated."[1] The United States Industrial Commission found that as regards railroads: "In the long run excessive capitalization tends to keep rates high; conservative capitalization tends to make rates low."[2]

This indirect influence of stock watering toward excessive rates and prices becomes effective in two ways. The existence of fictitious capital conceals from the public the high rate of return that is obtained on the true valuation, thus preventing effective action for a reduction in prices and charges; and it sometimes causes the rate-making authorities to allow rates to be sufficiently high to yield something to the investors in the inflated capital. If a trust or a railroad has issued stock having a par value of twice the capital invested, its rate of dividend on the entire capitalization will be only one-half the rate of interest that it is receiving on the investment. If it pays, for example, seven per cent on all its stock, it will be getting fourteen per cent on its genuine capital. While the consumers of tobacco, or the patrons of a railroad, would raise no out-

[1] Taussig, "Principles of Economics," II, 385, 386.
[2] Final Report, p. 414.

cry against seven per cent dividends, they would probably begin to agitate for an enforcement of the anti-trust laws, and for a reduction in freight and passenger charges, if they realized that they were providing for dividends of fourteen per cent. Nor is the public adequately protected by government investigations of trusts and regulation of railway rates. Despite the anti-trust laws, many American monopolies have for many years received exorbitant profits through excessive prices imposed upon the consumer; and in many of these instances overcapitalization and its resulting concealment of real profits have been of considerable assistance to the extortionate monopoly. In fixing railway rates, the Interstate Commerce Commission, and the various state railroad commissions, have been seriously hampered by their inability to determine the real investment of the roads, and to separate the genuine from the fictitious capitalization. Not until the year 1913 did the national government begin the task of making a valuation of interstate railroad property, and the work is not yet completed. Very few of the states have made valuations of the railroads within their borders. In the meantime it is certain that many of the rates fixed by both the national and the state bodies will continue, as in the past, to be higher than they would have been if the true value of the railroads were known and accepted as the basis of freight and passenger charges.

The second bad effect of stock watering on the consumer is seen when rate-fixing bodies deliberately permit the charges of public service corporations to be high enough to include some returns on that portion of the capitalization which is fictitious. It is very difficult for such authorities to resist entirely the plea of the "innocent investor." Consequently, railroad commissions and other rate-making authorities, and even the courts, have occasionally made some provision for dividends on the "water." Chairman Knapp of the Interstate Commerce Commission admitted a few years ago that, in considering the reasonableness of a

given rate, this body took into account the financial condition, and therefore the capitalization of the railroad.[1] In 1914 and 1915 practically all the great railway systems of the United States made powerful, and in a measure successful, appeals to the Interstate Commerce Commission for a rise in rates on the ground that they were unable to pay the normal rate of interest on their securities, and hence could not obtain on advantageous terms new capital needed for improvements. Had the capitalization of the roads been kept down to the actual investment, most of them would have been able to pay the competitive rate of interest on all their stock, and still have a sufficient surplus to command excellent credit.

The Moral Wrong

When prices or charges are made high enough to provide returns on fictitious capital, the consumer is treated unjustly. As we have shown more than once, the consumer cannot rightfully be required to pay for the products of a monopoly at a greater rate than is necessary to provide the competitive rate of interest on capital in the average conditions of efficiency. If some concerns are able to sell at this price, and still obtain surplus gains, they have a right thereto on account of their exceptional productivity. But the capital upon which a monopolistic concern has a claim to the prevailing rate of interest is genuine capital: that is, the actual investment as interpreted above, not an inflated capitalization. The consumers may justly be required to pay for the use and benefit of actual productive goods; but it is not just that they should be compelled to pay for the supposed use of a capital that has no concrete reality.

The stockholders of the monopolistic corporation which imposes upon the consumers exorbitant prices or charges through the instrumentality of inflated capitalization, can become guilty of this injustice in two ways: by promoting

[1] Final Report of the Industrial Commission, p. 413.

the improper capitalization; and by getting dividends on stock for which they have not given a fair equivalent. As a rule, the greater part of such guilt and responsibility rests upon certain special and powerful groups among the stockholders. For example; the J. P. Morgan syndicate which organized the United States Steel Corporation received for that service securities to the value of $63,-500,000. "There can be no question," says the Commissioner of Corporations, "that this huge compensation to the syndicate was greatly in excess of a reasonable payment."[1] The syndicate was able to exact this stupendous sum mainly because some of its members were also in control of some of the companies that were brought into the combination. "In other words, as managers of the Steel Corporation these various interests virtually determined their compensation as underwriters."[2] In the opinion of the minority members of the Stanley congressional investigating committee, "such a sum bore no relation whatever to the service rendered, the risk run, and the capital advanced."[3] The majority of the committee characterized the transaction in even stronger language. It is clear, therefore, that the syndicate committed injustice toward the consumers both by organizing a monopoly which afterward imposed unjust prices, and by taking millions of dollars in securities which its members did not earn, and on which they received interest through the exorbitant prices. While this transaction is exceptionally conspicuous, it is substantially typical of the methods by which many powerful monopolies have watered their stock to the detriment of the public, and the advantage of a small group of directors and financiers.

The "Innocent" Investor

Is the State obliged to protect, or is it even justified in

[1] Report on the Steel Industry, p. 38.
[2] Idem, p. 39.
[3] *Chicago Record-Herald*, July 29, 1912.

protecting, the innocent victims of stock watering? That is to say, should rate-making authorities fix the charges of public service corporations high enough to return some interest to the purchasers of fictitious securities? All the facts and presumptions of the case seem to demand an answer in the negative. In the first place, it is impossible to distinguish the "innocent" holders from those who were fully acquainted with the questionable and speculative nature of the stock at the time it came into their possession. In the second place, the civil law has never formally recognized any such claim on the part of even innocent investors, nor any such obligation on the part of itself. It has never laid down the principle that any class of investors in fictitious stock has a legal or moral right to obtain the normal rate of interest on such stock through the imposition of sufficiently high charges upon the consumers. Nor have the courts, except in isolated instances, sanctioned any such principle. On the contrary, the Supreme Court of the United States, in the case of Smyth *vs.* Ames, declared that a railroad "may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization." In the third place, when we consider the matter from the side of morals we see that the innocent investors are not the only persons whose rights are involved. If charges are placed high enough to cover interest on fictitious capital, the cost and the injury fall upon the consumers. The latter have a right to the services of utility corporations, such as railways and gas companies, at a fair price; that is, a price which will return to the capital put into the concern the prevailing rate of interest. To require them to pay more than this, is to compel them to give something for nothing; namely, to provide interest on capital which does not exist, and from which they receive no benefit. When, therefore, the State intervenes to secure fair charges for the consumers, it should base them upon the capital actually

invested and used in the business of public service. At least, this should be the general policy.

Frequently, however, the State has permitted overcapitalization, and charges sufficient to pay normal dividends thereon for long periods of years. Has it not thereby encouraged investors to cherish the expectation that these high charges would be permitted to continue, and that the fictitious stock would remain indefinitely as valuable as when it came into their possession? Is it not breaking faith with these investors when it reduces charges to the basis of the actual investment? A sufficient answer to these questions is found in the fact that the State has never officially sanctioned the practice of stock watering, nor in any way intimated that it would recognize the existence of the fictitious stock when it should take up the neglected task of fixing fair rates and charges. At the most, the civil law has merely tolerated the practice and the resulting extortion upon the public. And there has never been a time when the greater and saner part of public opinion did not look upon overcapitalization as at the least abnormal and irregular. Neither from the civil law nor from public sentiment have the devices of inflating capitalization received that measure of approval which would confer upon investments therein the legal or the moral status of vested rights. To the "innocent investor" in watered stocks the maxim, *caveat emptor,* is as fairly applicable as to the man who has been deceived into lending his money on insufficient security, or the man who has been induced by the asseverations of a highly imaginative prospectus to put his money into a salted gold mine, or the man who buys stolen goods from a pawnshop, or the man who because of insufficient police protection loses his purse to a highwayman. In all these cases perfect legal safeguards would have prevented the loss; yet in none of them does the State undertake to make the loss good to the innocent victim.

Such seems to be the strict justice of the situation as between the consumer and the innocent investor. It may sometimes happen that a particularly grave hardship can be averted from the latter at a comparatively slight cost to the former. In such a case equity would seem to require that some concession be made to the investors through the imposition of somewhat higher charges upon the consumer.

Magnitude of Overcapitulation

Probably the majority of the great steam railroads, street railways and gas companies that were organized during the last quarter of the nineteenth century inflated their capitalization to a greater or less extent. Since the year 1900 the trusts have been the chief exponents and illustrations of the practice. According to President Van Hise, "the majority of the great concentrations of industry have gone through two or three stages of reorganization, the promoters and financiers each time profiting greatly, sometimes enormously."[1] For example; in 1908 the "water in the American Tobacco Company was estimated by the Commissioner of Corporations at $66,000,000; the United States Shipbuilding Company diluted its twelve and one-half million dollars of capital with more than fifty-five millions of "water"; the United States Steel Corporation contained at the time of its organization fictitious capital to the amount of $500,000,000; and at least fifty per cent of the common stock of the American Sugar Refining Company represented no actual investment.[2] Owing to the penetrating and widespread criticism, and the government investigations and prosecutions of the last few years, the practice of stock watering has very greatly diminished. Perhaps the most flagrant recent example is that of the Pullman Company, which according to the testimony of R. T. Lincoln before the Federal

[1] Op. cit., p. 28.
[2] Cf. Van Hise, op. cit., pp. 29, 142, 149.

Commission on Industrial Relations, distributed among its stockholders $100,000,000 in stock dividends between 1898 and 1910.

Nevertheless the temptation to inflate capital will exist until the device is stringently prohibited by law. Both the nation and the states ought to adopt the policy of forbidding the sale of stock at less than par value, and restricting issues of stock to the amount required for the establishment, equipment, and permanent betterment of a concern. including a sum to cover the loss of interest to the investors during the early period of the business. Any extraordinary risks to which an enterprise is liable can be protected by the simple device of allowing a correspondingly high rate of interest on the securities. With such legislation enacted and enforced, neither the investor nor the consumer could be deceived or defrauded; and the financing and management of corporations would become less speculative, and more beneficial to the community. The present chapter may be fittingly closed with a moderate and significant statement from the pen of Professor Taussig: "It is doubtful whether the whole mechanism of irregular and swollen capitalization was at any time necessary or wise. Why not provide once for all that securities shall be issued only to represent what has been invested? . . . It is sometimes said that freedom, even recklessness, in the issue of securities was a useful device, in that it enabled the projectors to look forward to returns really tempting, and at the same time concealed these returns from a grudging public. . . . A more simple and straightforward way of dealing with the issue of securities might thus have dampened in some degree the feverish speculation and restless progress of railway development. But a slower pace would have had its advantages also, and, not least, restriction of securities would have saved great complications in the later stages of established monopoly and needed regulation." [1]

[1] Op. cit., II, 387, 388.