

BRIEFER COMMUNICATIONS.

THE ETHICS OF STOCK WATERING.

There seems to be a tendency in present day discussions of economic problems to emphasize the ethical bearings of those problems and to appeal to conceptions of justice, as well as to those of utility.

The proposals for various forms of municipal and state socialism, the Utopian visions of all sorts, and the ill-defined but oft expressed yearning for change, in which the dissatisfaction with present industrial conditions is expressed, all have their ultimate basis in ideas of justice.

That great injustice is done not only by individuals, but also by associations of individuals, and the government, is a common belief and rightly so; but some reforms proposed in the name of justice "o'er shoot the mark" and would instead of eliminating injustice only shift its incidence.

In this discussion it is assumed that justice as well as utility demands that each man's share in the fruits of production should correspond to the relative value of his contribution to the welfare of society.

Let us now candidly examine as to the just basis of reward for several kinds of contributions to production, which partly through inadequate regulation, partly through unjustly stringent regulation, often receive at the present time shares out of all proportion to their value.

It may be said with some truth that the promoters and capitalists, who in the main furnish the contributions to be considered, are better able to take care of themselves than some other classes. Our object is not to champion any class, least of all one that little needs it, but to arrive at a better understanding of the just proportion of the fruits of industry due to the promoters, organizers and capitalists of transportation and other business enterprises; remembering that weakness does not make right any more truly than might does; and that a general recognition of the just division of the fruits of production is essential to both the existence of equitable legislation and its enforcement.

In the fields of invention, of letters, and of art, genius is not left to be its own sole reward: the patent office vouchsafes to the inventor, so far as it can, control of the gains to the world through his invention; the man of letters, the musical composer and the artist are protected in the enjoyment of property rights in their creations; and

[509]

this is recognized to be just and right. The man who conceives and plans a great business undertaking is no less a creator, a genius; but his rewards, though usually ample, must be secured in a more or less illegitimate way, even under existing statutes; while his success in selling his capitalized creation incites a cry for more strenuous if not prohibitive legislation.

The conception, the originating, the organizing of an enterprise is the fundamental element of value in it. Without that element energy is misdirected or lies dormant; capital is non-productive; and the people are without some means of employment, of economy, of development, of comfort, or of enjoyment, which otherwise they might possess.

To urge that many enterprises are conceived which bring no profit to those concerned in them nor benefit to the people, serves only to enhance the value of that creative element in any successful enterprise. If a man is so fortunate as to combine in himself all the necessary elements for a business undertaking, this paper would have only a theoretical interest, as to what proportions of his profits should be credited to ingenuity, to push, to capital, etc. In a partnership the problem is comparatively simple, for the valuation of each man's contribution to the firm is purely a matter of mutual agreement; but when, on account of the nature or of the magnitude of the operations contemplated, or for any other reason, the corporate form is adopted, the state steps in and attempts to define the kind of property which may be valued in determining the capitalization of the enterprise. The corporation is a creature of the state and the state has an unquestioned legal right to place upon corporations any limitation whatever. But such legislation on the subject as now prevails in many states breeds corruption and perjury, and would, if enforced, stifle many of the most widely beneficial undertakings. But existing legislation and the more stringent measures advocated in some quarters, are to be opposed not so much for these reasons as for their injustice, in that such legislation attempts to deprive those contributions to an enterprise which are in any other form than material wealth of all interest in it.

Next to the fundamental creative element in any business undertaking is that element which *compels* the issue conceived; energy, persistence, "push." The most brilliant and the most workable plan may amount to no more than a dream, without push; capital may rot, and men may starve. The energy that executes the brilliant and far-reaching conception is not justly repaid in day wages any more than the genius which created it. He who takes the ideas of a genius, worthless as ideas, clothes them with outward form and makes them effective; he who takes the gold of the capitalist and gives to it a

productive power; he who takes the strong and willing laborer and directs his work in more healthful and profitable channels, is entitled to no mean share in the benefits brought about through his efforts.

The industrial history of the past fifty years records many cases of large risks taken through which the world has greatly benefited, even though the risk takers may have fared but ill. It is safe to say that, if that quality of mind which is willing to take risks were entirely eliminated from society, and all the other qualities which give value to an undertaking, such as genius, push, labor, capital, were retained, the increase of productiveness would be immeasurably retarded, and ere long we might find ourselves in an era of industrial retrogression instead of progress.

It is perhaps harder to arrive at a proper valuation of this element than of the others entering into a business; risk taking may be rashness, and its value then better represented by a minus quantity; and even when coupled with the greatest shrewdness loss may result. The first difficulty is eliminated by the consideration that the difference in value between a good risk and a bad risk is quantitative, in the same way that judgment is a quantitative factor in the value of genius or of push. As to the second difficulty, the possibility of a losing issue from a good risk is the very thing which enhances the value of the risk taking; the value of this quality varies directly with the chance of loss.

This consideration suggests the justice of safeguarding the interests of investors by affording them information as to the exact nature of the risk proposed, so that the possibility of loss may not be shifted from the shoulders of risk-takers to innocent investors, intending a less risk.

The discussion of other elements or qualities of value in a business undertaking, such as experience, acquaintance, and many personal qualities, offers an inviting field; but its bearing would be on the just valuation of a person's services to any one of several businesses rather than on the proper valuation of one's contribution to a special new enterprise.

From the foregoing considerations it is seen that a portion of the profits of an undertaking, if it proves successful, is due to the person or persons who conceive it; another portion to those who by their energy, persistence and executive ability organize and carry out that conception; and another portion, over and above a legitimate rate of interest on investments, to the men who take a risk by furnishing the money necessary for the establishment of the business. These portions of earnings are entirely apart from any salaries or wages for services in the prosecution of the business.

Let A, B and C represent respectively the interests above named, D the money investment in the enterprise, and E the managing services; whether contributed each by different individuals or two or more of them by the same person. In the case of a co-partnership, A, B, C, D and E will each have an interest in the profits of the firm, the proportion to be determined by mutual agreement of the parties, without the interference of the state and without calling forth any critical interest from the public. We will therefore confine our discussion to the application of these principles to a corporation, which is not only to a greater extent under the eye of the public and under control of the state, but also a more perfect instrument for rendering justice to all the interests concerned.

It is evident that E, like wages, supplies, etc., is a first charge upon the gross earnings, independent of any net profit or loss, and is therefore entitled to salary, but to no contingent interest in profits, except under some plan of profit sharing, so called, applicable to all employees alike.

D is entitled to the first claim upon both property and net earnings, limited, however, in the first case to the amount of money invested, and in the second case to a fair rate of interest thereon, as an investment: D is fairly represented, therefore, by bonds or preferred stock of the corporation. Practically the element of risk taking cannot be entirely eliminated from the bond and preferred stock issues of a corporation, and in so far as it is not eliminated the remarks as to C, which follow, are applicable.

A, B and C are all alike entitled to a junior interest in the property and to a share in the net earnings; for, as we have seen, the value of the property and its earning capacity are largely due to the genius, A; the push, B; and the risk taking, C. What is termed the "unearned increment" is often most truly earned; earned by the very factors, A, B and C, and not belonging to the public any more than interest earned by private capital. The very fact that an enterprise is successful demonstrates the value of those factors in its inception; and if it is not successful the rewards of A, B and C should be valueless. Those rewards may fairly be taken, therefore, in common stock of the corporation.

What is the present practice, what are the facts in regard to these matters? On the one hand there is over-capitalization to an enormous extent, so that in many cases the entire capital stock does not represent any investment of tangible property, nor any fair valuation of other contributions to the enterprise; on the other hand, there is legislation aiming to do away entirely with the issue of stock or bonds for any other than a cash or absolutely equivalent property

consideration. This legislation, especially in Massachusetts and New York, together with other measures for the regulation and taxation of corporations, has had considerable effect in correcting the more open and flagrant abuses of over-capitalization; but the theory upon which this and other proposed legislation is based is that nothing but money or its equivalent in tangible property can properly form a basis for capitalization. This theory we believe is shown to be unjust. And experience shows it to be unworkable; the cases are few and isolated where the spirit of such legislation is obeyed. The promoter will not work for nothing; the rare business genius who can plan and execute great enterprises and bring them to a successful issue, circumvents the law, if necessary, in order to get his by no means small reward; the capitalist who embarks in an undertaking involving great risk must see a correspondingly great reward if the venture prove successful.

The value of contributions to an undertaking not in tangible property or cash should be generally recognized by capitalists, by the public, and in legislation. The proper apportioning of the securities of a new corporation to the different interests represented by A, B, C and D might well be the subject of mutual agreement between the parties, to be reviewed and passed upon by a State Board of Corporation Commissioners, one of whom should be a competent engineer. In case mutual agreement was not possible, such a board of commissioners should be empowered to make the apportionment after a hearing of the parties. In any event the consideration for which securities are issued should be a matter of public record. Legislation, and the rulings of such a commission, should permit the issue of securities for cash at less than their par value, the price to be determined, or approved, by the commission, in inverse proportion to the risk involved in the purchase of the securities. The securities allotted to the interests represented by A, B and C, if more than one class of securities is issued, should be of the junior classes, corresponding to the English "vendors' shares" issued for good-will, etc., in the case of the capitalization of a going business.

Such a board of corporation commissioners might at first include one or more members of existing boards of railroad, gas and electric light commissioners, etc. The duties of the new board are already performed in part by existing boards in some states, notably Massachusetts.

But it is beyond the scope of this paper to do more than call attention to the value of contributions to the legitimate capital of a corporation other than those in cash or tangible property, and to suggest the lines along which legislation should be modified for the purposes

of properly and justly regulating the capitalization of corporations and providing for the fair remuneration of those interests now wholly or partially ignored. Legislation on the lines indicated, with a commission as competent as our best railroad and other state commissions, would encourage the inception and incorporation of sound undertakings by offering commensurate rewards to all the participants in them; and would also enhance the value of properly issued securities by making public the kind and amount of consideration for which stocks and bonds are issued. It would likewise discourage, if not altogether prevent, the launching of unsound enterprises, by which the promoters are too often enabled to foist upon a deceived public "securities" of vanishing value, and thus unjustly procure a cash reward for their genius and push instead of a reward in common stock, which, if the business fail, is properly valueless.

What is urged, then, is a fair and open recognition of the just dues of the different participants in a business undertaking; a more just and intelligent state regulation of corporations; a public record of the true consideration for every issue of securities.

T. C. FRENYEAR.

Buffalo, N. Y.