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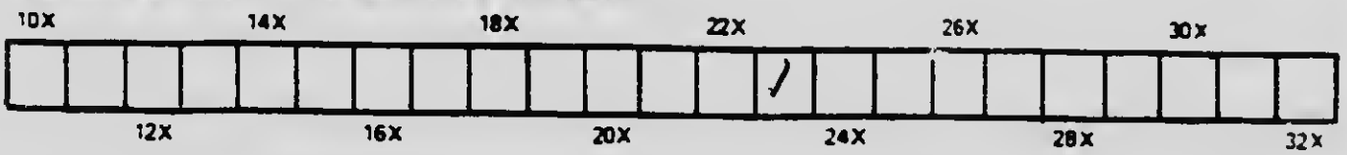

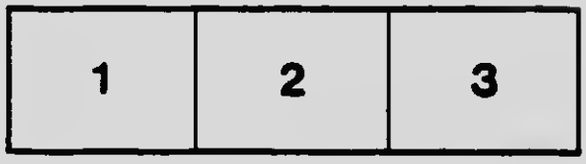

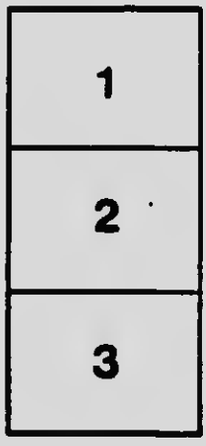

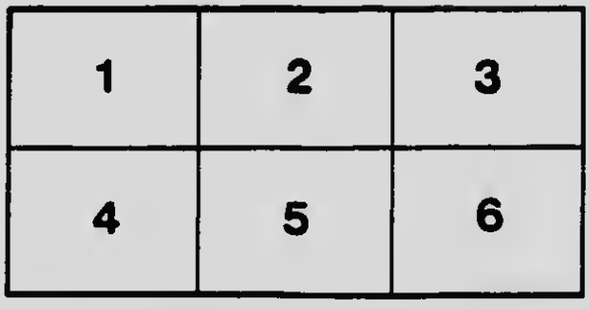

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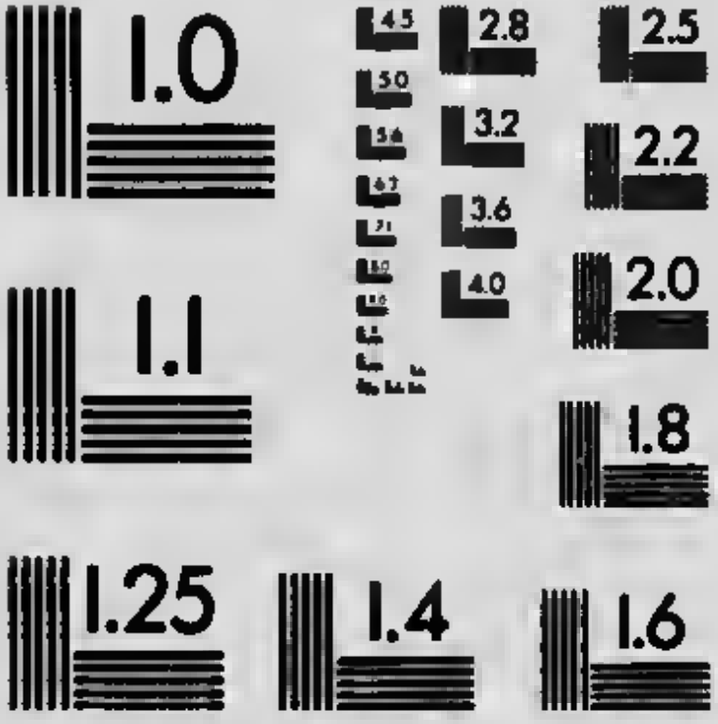

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Queen's University

Course in Banking

LESSONS I-VI-III

Corporation Finance

Queen's University.

CORPORATION FINANCE.

Introduction.

It should be carefully observed that the study of corporate production, organization and administration does not involve the trust question, that is, the benefits or the reverse of mergers, combines and amalgamations of industries to such an extent that the market is dominated with respect to both the output and the price of the commodities concerned. Rather, the corporation problem has to do with the organization and functions of the type form of business organization in the modern industrial and financial world. The trust question constitutes a special problem in itself. It deals with one particular phase of the corporate organization of business, and may be said to furnish a special field of investigation of its own. The trust question has been considered in the course in General Economics, and will be studied in this connection only in so far as we need to consider the financial aspect of the merger movement.

In this course we propose to cover such phases of the corporation question as will prove of special value and importance to the banker. Among other aspects of the problem it is proposed to investigate the following: The corporate form; the legal status of the corporation; corporate organization; types of business corporations; the source of corporate funds; bonds and stocks; corporate promotion and consolidation; marketing securities; the function of the underwriter; the disposition of gross earnings; and receiverships and reorganization.

LESSON I.

The Corporation Form: The Interior Organization of the Corporation.

In examining the *form* that the corporation assumes we discover that there are two main types: the "non-stock" corporation and the "stock" corporation. In the first are included churches, hospitals, chartered clubs, universities, and other social and charitable institutions. In all these the members share in all the benefits of the particular organization irrespective of the amount of money contributed. Such institutions exist to confer a common benefit or to serve the community at large. There are some exceedingly interesting and important problems that one might consider in this connection; but they lie beyond the range of interest of the banker, for the most part, and we may therefore at once pass to the second division of the subject—namely, stock corporations.

Stock Corporations.

To this class belong all business corporations, with the exception of mutual insurance societies and stock exchanges. Both of the latter are simply clubs which offer to their members certain valuable privileges. Stock corporations, on the other hand, are constituted to carry on business ventures. Their profits are distributed according to the number of shares possessed, and each stockholder is an owner of the corporation and its assets to the extent of the number of shares that he holds.

What is a Corporation?

In the famous Dartmouth College case, decided in 1819, Chief Justice Marshall of the United States Supreme Court, defined a corporation as "an artificial being, invisible, intangible, and existing only in comtemplation of law." Blackstone, the great English legal authority, defines a corporation as follows: "A corporation is an artificial person created for preserving in perpetual succession certain rights, which being conferred on natural persons only, would fail in the process of time." This statement emphasizes the most distinctive feature of the corporation, namely, its artificial personality. The corporation is a new creation, quite distinct from the persons who have organized it. From this it follows that the corporation is not broken up by the death or withdrawal of any owner of stock in it. In the second place, it has the right to buy and sell property, and to enter into contracts for itself, just as

any individual may do. And lastly, it may sue and be sued in the courts, without thereby involving any of its owners.

The reader should keep clearly in mind the great fundamental fact that the corporation is a separate, distinct artificial person. Wihtin the last few years, however, the courts, both in Canada and the United States have shown a tendency to go behind this artificial personality and to hold the owners and managers responsible for financial losses, especially in case of fraud. Clark, the author of a standard legal American work, says:

"That a corporation is a legal entity, separate and distinct from the members who compose it, is a mere legal fiction, introduced for the convenience of the corporation in transacting business, and of those who do business with it; and, when urged to an intent and purpose not within its reason and policy, the fiction will be disregarded, and the fact that the corporation is really a collection of individuals will be recognized, even at law. Courts of equity, in every instance, look behind the corporate entity and recognize the individual members, and will do so whenever justice requires."

> *To-day, more than ever, the courts as well as public opinion are insisting that those who control corporations cannot shield themselves behind the legal fiction of the corporate entity, but must assume responsibility as well as enjoy rights. Nevertheless, the limited liability principle does protect the stockholder to an extent that would be impossible in the case of an individual enterprise or a partnership.*

Nevertheless, it should be understood that the corporation's existence, property, contracts and debts all pertain to the corporation as such, and not to the individuals who own and control it. While the corporation itself connot think or act the law surmounts this difficulty by regarding the managers and officers of the corporation as its agents empowered to fulfil its functions and operations.

Why the Corporate Form of Industry has been Developed.

At first glance it might appear that the corporate organization of industry depends more upon legal fictions than upon common sense principles. And yet the experience of the race goes to show that the corporation is absolutely essential for the proper functioning of business on a great scale. Archaeological research proves that the corporation was known in Babylon when that city was a commercial metropolis and the wonder of the world. The Romans developed the corporation idea to a

high stage; indeed, Blackstone maintains that the modern corporation is the lineal descendant of the Roman. However that may be it yet remains true that the corporate form of business organization must present peculiar advantages, else it never would have persisted or have become so wide-spread. Among its advantages are the following:

Adaptability to raising large amounts of Capital.

In former times corporations were almost altogether confined to large enterprises, and found favor because of the facilities they afforded for raising large amounts of capital. Not even the richest individual—not even the late Lord Strathcona, or the present Lord Northcliffe or Andrew Carnegie or John D. Rockefeller—would be able to build and operate a great railroad railroad system like the Canadian Pacific. But even if Rockefeller or Rothschild could build out of his own resources such a giant enterprise, he would not care to do so. The reason is obvious: men of great wealth cannot put their money in one undertaking. They wisely invest in many different enterprises; so that a failure in one direction will be more than made good elsewhere.

Nor can a partnership, great and powerful as it may be, take the place of the corporation. For one thing, it would be exceedingly difficult to harmonize inevitable differences of opinion, and to co-operate efficiently where tens or hundreds of millions were involved. It is safe to say that there cannot be found in the history of the world a billion, or even half a billion dollars of capital raised and operated under a partnership agreement. Even the greatest fortunes are insignificant in comparison with the total wealth of such nations as the United Kingdom, the United States, France or Germany.

Now perhaps the chief advantage of corporations is that they are able to collect and make use of the small capital holdings of hundreds of thousands of individuals.

> *The corporation sets up no limitations, in securing capital, based upon national prejudices. English capital to the extent of* $19,000,000,000 *has been invested in all quarters of the globe; among civilized and semi-civilized peoples; from China to Peru. Canada has drawn capital from England, Holland, Belgium, Switzerland, France and Germany. The corporate form of business organization makes possible to a greater degree than ever before the "internationalization" of capital.*

Permanence. The corporate form of industry is further characterized by its permanence. The individual business passes away with the death of its owner. A partnership is also

automatically dissolved by the death of one of the members of the firm. Of course the surviving partners may form a new firm, and take over the business of the deceased partner. The corporation, on the other hand, does not cease with the death of a stockholder, even if he has owned 99 per cent of the stock. The corporation is an artificial being, a creature of the law and not dependent upon the existence of its stockholders. It is organized in such a way that if one officer withdraws or dies a successor may readily take his place. This feature of the corporate organization is important, and explains in large part why this type form of business has so largely displaced the partnership.

Centralization of control. Under the corporate form of business organization control is centred in a particular group of officials. An owner of stock, and thus an owner in part of the entire business, has no authority to transact business in behalf of the corporation unless he is likewise an official. Each officer has certain specified duties and obligations; and hence contracts, unless made with the proper officers or agents, are invalid. When each official knows that he can operate only in a special and restricted field, and that he is responsible to his superiors, the corporation is able to enforce a discipline and secure a smoothness in operation almost unattainable in the partnership and other types of business organization.

> *The corporation could never carry on its functions with smoothness, efficiency and precision were it not for centralization of control. This is one of the chief characteristics of corporate action—that those who have no special aptitude for the management of capital can own property and yet surrender its control to those who, by nature and training, are in a position to get out of it the best results.*

Transferability of ownership. A fourth advantage of the corporation is the ease with which its ownership can be transferred. As the ownership of a corporation is represented by shares a stockholder may sell any part, or all, of his holdings without interfering in the least with the stability of the corporation. And further, as ownership does not in any real sense signify control or management it is not necessary to find a buyer acceptable to the other partners in the enterprise, as is the case in the ordinary business in the form of a partnership. All manner of people, even although they may be devoid of business ability, may purchase corporation securities and to the extent of their holdings become owners of the enterprise. The result is that both the corporation itself and the individual owner of shares can find a broader market with

greater facilities for the selling of securities than can the owner of a partnership interest or the single proprietor of a business, however large these may be.

Limited liability. The fifth, and one of the most important, advantages of all is that of limited liability. Generally speaking—and with the exception of the double liability of bank stockholders—the owner of any corporation security can consider that, although he may possibly lose what he has once invested, he cannot possibly lose more than that amount. The partner, on the other hand, may not only lose what he has invested in a firm, but in addition he may become personally liable for all the unpaid debts. If a corporation fails, on the other hand, and its debts prove greater than its assets, the creditors have no claim on the property of the stockholders beyond what has been invested in the failed business. As has been said, in the case of the chartered banks of Canada, the liability incurred covers not only the amount invested but an additional sum equal to the par value of the stock held. In the state of Minnesota this double liability feature applies to most financial corporations. But even here it should be noted that the liability is strictly limited in amount, and that it does not cover the entire possessions of the stockholder as is the case in the individual business or in the partnership. This feature of corporate enterprise has done as much, perhaps, to popularize the corporation as any other characteristic of this type of busines.

> *The feature of limited liability is most important, and perhaps has done more than any other one factor to extend the corporate form of business enterprise. By means of it investors can diversify their interests, and protect themselves against exceptional losses. It is especially helpful in limiting the possible losses of widows, minors and estates held in trust. By its means, moreover, capital has been attracted from all quarters of the world to new fields of enterprise everywhere.*

Disadvantages of the corporate form. In view of the many solid advantages of the corporate organization of industry it might be a matter of surprise that all industries do not assume this type. The reason why this is not done is that there are minor disadvantages which more than offset the gains, in certain cases. These may be enumerated as follows:

(1) *Increased expense.* Both in Canada and the United States the local governments—the state and provincial—impose taxes of one kind or another upon corporations, in addition to the municipal taxes on property. These taxes are,

in general, quite small in comparison with the wealth of the corporations concerned. The United States government also imposes a tax on corporate income; but as yet there is no similar tax levied in Canada. In addition legal assistance is necessary to incorporate a business; and all these charges, as a result, militate against the forming of corporations, especially where the enterprise is small and comparatively limited in scope.

(2) *Limited Powers.* As corporations receive only specific powers they may be hampered in the extent of their operations; although a good corporation lawyer will generally have placed in the charter all necessary rights and powers to carry on the business. If not, it is always easy to form a new corporation for whatever purpose is desired.

(3) *Limited credit.* A capitalist will, other things being equal, prefer to lend to an individual or to a partnership rather than to a corporation, as the liability in the former case is not limited. In a small corporation this difficulty may be overcome by the officers or certain stockholders personally endorsing the corporation's notes, or bills payable. By so doing they lose, of course, the advantage of limited liability, but they retain all the other advantages of the corporate form. Nevertheless, there are some forms of business activity in which the personal element is so prominent as to make the corporate form of business organization undesirable, Firms of accountants, business advisers and systematizers, on account of the prominence of the personal liability feature, can not with advantage adopt the corporate form of business organization.

(4) Governmental control. Lastly, it may be noted that certain concerns are strongly averse, for good reason, to adopting the corporate form because of the publicity involved and government supervision, Either because they are making very large profits, or because the business is what it ostensibly purports to be, they do not desire to adopt the joint stock form of carrying on their enterprise.

Thus, it may be said in conclusion, that the advantages far outweigh the disadvantages of the corporate organization of business. We are justified, therefore, in predicting that the tendency toward incorporating enterprises as joint stock companies will Increase and become strengthened as the years pass by.

II. Interior Organization of Corporations.

It is necessary to consider at this point the relation to each other of the various groups who are directly interested in a corporation. These are:

I. The Stockholders.
II. The Creditors.
III. The Directors.
IV. The Officers.

It is necessary that every corporation should be so organized that the rights and duties of these groups should be known and enforced.

The stockholder, of course, owns the business to the extent of his holdings: but his rights, although fundamentally the same as those of the owners of private property, are necessarily abridged or modified because of the form his property assumes. The private owner of property, for examlpe, has the right to sell, or destroy or give away that property; but a stockholder, on the contrary, cannot sell or destroy his proportion of the corporation's assets, because under the corporate form he has committed the care of the assets to other people.

The rights of stockholders as a body are:

(1) To elect directors.

(2) To amend the charter or by-laws.

(3) To sanction or veto the selling or mortgaging of the permanent assets of the corporation.

(4) To dissolve the company.

The third point is rather important. The Dominion Companies Act provides that the directors of a company may borrow money upon the credit of the corporation or issue bonds and debentures for the purpose of raising capital provided that they are authorized so to do by a special by-law passed by a vote of not less than two-thirds in value of the subscribed stock of the company. In general the companies acts of the several provinces follow the same precedure. In the United States, in some of the states the courts assume that the stockholders have turned over to the directors the complete management of the business without any reservation whatsoever. As a general rule, the directors, in order to protect themselves, prefer to have the officially expressed concurrence of the stockholders whenever the permanent assets of the corporation are being sold or mortgaged. A clause is often placed in the charter, or in the by-laws, requiring unanimous consent or the consent of a very large percentage of the stockholders in order to validate the sale or mortgage of permanent assets.

Rights of Individual Shareholder. The rights of the individual shareholder are four in number:

(1) To receive notice of, and to participate in, all stockholders' meetings.

(2) To share in the assets of the corporation, according to the proportion of stock held. at its dissolution.

(3) To share in dividends according to the proportion of the stock held.

(4) To inspect the accounts of the corporation.

If the stockholder does not go himself to any meeting he may delegate some other person to represent him. The instrument that confers the right on a second person is called a "proxy." The proxy may limit the powers of the holder in many ways; it may be good for only one meeting, may be limited to a certain time and for a certain purpose, and may require that a certain kind of vote is cast. The use of the proxy is very extensive in Canada and the United States; but in England the stockholders are more likely to appear at the annual meetings. Owing to the great distances to be traversed on this continent a constructive attendance of stockholders through the assigning of their stock to representatives by means of the proxy becomes, in the case of the large corporations at least, almost essential.

The right to dividends. One should carefully note what is involved in the third right mentioned—the right to dividends. In the first place it should be clearly understood that this right does not involve a claim to share in the earnings, but merely in the dividends declared. In the second place it should be noted that a company may be getting very large yearly profits, and yet a stockholder may not draw any dividend whatsoever. He can get at earnings only when dividends are declared. Directors alone have the legal right to declare dividends and cannot be compelled to do so unless in their own judgment such a policy is regarded as best in the interests of the corporation. Since the outbreak of war several large companies in Canada have "passed" dividends. The courts will not interfere with the policy of the directors, in this particular, unless it can be found that fraud or mismanagement is involved in the question.

The right to information. This is not a complete right to all information concerning a corporation's affairs; for otherwise a rival concern could buy a single share of stock and gain information that would be prejudicial to the company's interests. In most cases, both in the several provinces of Canada and in the states of the American Union the stockholder is entitled to a statement of the profit and loss account of the preceding year and to the balance sheet at the close of the company's fiscal year. But the movement in favor of publicity of corporation accounts is now so strong, and the force of public opinion behind it is so great, that almost all the corporations give voluntarily detailed statements of their position in their annual reports. In Canada, if shareholders are dissatisfied they may have an investigation of their company's affairs. This is obtained upon the application of shareholders representing not less than one-fourth in value of the issued capital

stock of the company, to a iocai judge. If he considers it necessary he may appoint an inspector to investigate the affairs and the management of the company. The company itself may, at the annual or at a special meeting, appoint an inspector for the same purpose.

The right of a shareholder to inspect the company's books is a common iaw right in Canada, and appears to be wider than the rights granted to stockholders in American corporations.

Section 91 of he Dominion Companies Act provides:

"Such books (stock transfer books and stock ledgers, iists of shareholders and directors, etc.), shaii, during reasonable business hours of every day, except Sundays and holidays, be kept open at the head office or chief piace of business of the company, for the inspection of shareholders and creditors of the company, and their personai representatives, and of any judgment creditor of a stockholder."

The right to inspect the book invoives aiso the right to make extracts therefrom.

Liabilities of stockholders. Sometimes corporations do not need aii the capitai that will be necessary later. They therefore ask from their stockhoiders oniy a percentage of their stock subscriptions at the begininng, and either set certain dates for the payment of the baiance or ieave it to be settled iatter by the directors. In the iatter case, it sometimes happens that the corporation becomes so prosperous that the balances are not caiied in, and the stockhoiders forget their existence. If the corporation, after many years, gets into difficuities the owners of the stock may find themseives confronted with a demand for the immediate payment of the unpaid instaiiments. Buyers of stock shouid, therefore, make sure that their certificaes are marked "fuiiy paid and nonasssesabie," or eise be perfectiy sure that they are in a financial position to meet installments that may have remained unpaid.

The payment of dividends out of capitai, it may be mentioned in passing, is forbidden both in Canada and the United States. Otherwise assets piedged to creditors of the corporation might be diverted to stockhoiders.

Rights of creditors. The creditors of a corporation may be divided into two classes: (1) secured creditors who have had set aside for them under some form of agreement certain assets or property to protect the fuii value of the debt; (2) the unsecured creditors who hoid a claim against the unattached assets of the Corporation. In either case the creditor has no voice in the management of the concern. Oniy in case of insoivency or bankruptcy may he step in and exercise any rights which may have been conditionally granted to him.

Powers and liabilities of directors. Both in Canada and the United States directors are required to be stockholders of record. It is true that a stockholder who controls a sufficient value of the stock may elect "dummy" directors to represent him, while he remains in the background. These "dummies" are actually stockholders of record; but by a secret agreement the stock certificate is endorsed back to the real owner, the latter actually owing the stock all the time. If the "dummy" does not do as he is directed the stock certificate is handed in and the director's name expunged from the books of the corporation.

But, in theory at least, the directors are suposed to represent all the stockholders. This is the reason why the directors are given control of all the officers and assets of the corporation. The powers of the directors are very extensive, and are set down in the by-laws of the company. As ageneral rule they have power, among other things, to fill vacancies in their own number until the next annual meeting of the company, to appoint and remove officers of the corporation, under limitations to modify or enact by-laws.

Under the Federal Companies Act of Canada it is provided that the directors shall not be less than three in number nor more than fifteen. The number varies from state to state in the American Union. In any case it is the practice to elect a standing committee—a sub-committee of the directors—to look after finances and the details of the business. There may be several such committees, each with its own particular duties. Th Uenited States Steel Corporation delegates a large part of its work to a standing committee of eight members known as the finance committee. This committee, between meetings of the full board of directors, has complette authority to settle most questions.

One of the most important officials of a corporation is the chairman of the board of directors. In large companies the chairman is a paid official to whom the president re[illegible]ts on the condition and business of the corporation. The ch[illegible]man, in a sense, represents the board of directors and the standing committees in the intervals between meetings. To him are delegated, between meetings, the full powers of the board.

The personal liabilities of directors may arise in four ways:

(1) By reason of neglect or wrong doing on their part that results in loss to the company.

(2) By issuing stock as fully paid when it is not fully paid.

(3) By paying dividends out of capital.

(4) By doing other acts that are especially prohibited by the laws of the land.

So long, however, as the directors do nothing wrong or fraudulent they are not subject to liability for any losses that occur through acting merely in their capacity of directors.

> *More and more, to-day, directors are recognizing the sacredness of the trust which has been reposed in them. It can be fairly said that directors have never had a higher sense of public duty than they have to-day. Not only so, but there is an increasing tendency both on the part of the people and of the courts to hold them strictly accountable for their actions, and thus to protect the stockholders as well as the creditors against fraud and the results of malfeasance of office.*

The efficiency of corporate organization. Enough has now been said to show just why the corporation has displaced most other types of business organization. It is primarily because the corporation works with the utmost efficiency. The stockholders provide the capital on the one hand; while on the other a great number of laborers and clerks carry on the work of the organization. Standing between and over these classes are the directors and chief executive officials, whose aim it is to see that the business is conducted efficiently and that it yields profits. Because of the smoothness and efficiency with which the machinery of these large business enterprises works they have gradually increased both in number and importance until today they dominate the whole field of industry, commerce and finance,

Questions for Review.

1. What are the chief points of difference between a corporation and a partnership?
2. Why was it that the corporation did not become a common form of business organization until the nineteenth century?
3. For what kinds of business is the corporate form advisable? What classes of products are likely to be produced on a large scale?
4. What are "non-stock" corporations? What are "stock" corporations?
5. In what sense may it be said that the "corporate entity" is a fiction?
6. Give examples of how the corporate form of organization has spread in industry and finance in Canada in recent years.
7. In what way, precisely, is the corporate form adapted to the raising of large amounts of capital?

8. Just why is the corporation more enduring than the individual business or the partnership? Why do not families continue for generations to retain control of a privately founded business?

9. Show how the corporation, from the point of view of control, is more effiecient than the partnership.

10. Can a share in a corporation be more easily transferred than a share in a partnership? Why?

11. What is involved in the principle of "limited liability?" Is the principle universally applicable?

12. Classify the advantages and the disadvantages of the corporate form of business organization.

13. What are the fundamental rights of the body of stockholders of a corporate?

14. What control have the stockholders over the sale or mortgage of the assets of their corporation?

15. What is a "proxy?" Name the fundamental rights of each stockholder. When is a proxy irrevocable?

16. What is meant by the "right of dividends?" Can stockholders force a board of directors to declare dividends, provided the company has earned large profits?

17. Has a stockholder a legal right to inspect the books of a corporation? What may the stockholders do to compel investigation of a company's affairs?

18. What are "dummy" directors, and how are they kept under control?

Questions for Written Answer.

19. What are the powers of a board of directors? May they delegate these powers to committees? To what extent are directors responsible for losses suffered by the corporation?

20. Compare the partnership with the corporation with respect to (a) ability to get new capital, (b) efficiency of the business organization.

21. What are the rights of (a) stockholders as a body; (b) of the individual stockholder?

22. Bring up any difficulty.

LESSON II.

The Legal Status of the Corporation; Methods of Incorporation.

As has been said, the corporation is created by law and has an entity of its own. Nevertheless this artificial person has no existence, powers or duties except such as are conferred upon it either by express statement or by implication. In other words, the corporation, as such, has no natural rights, but only artificial rights. To discover, therefore, what a corporation may or may not do we must look to the particular instruments which gave it being, and which control its actions. These are four in number:

(1) The constitution of Canada, and statutory legislation.
(2) The general companies acts.
(3) The charter of the corporation.
(4) The by-laws of the corporation.

The most important question from a constitutional point of view is the right of corporations having a Dominion charter to carry on busines freely in the nine provinces of this country. The question has given rise to strong differences of opinion between the governments of the respective provinces and the Dominion authorities. The question at issue is the extent of the authority of the provinces in regulating corporations, provincial or otherwise, that are carrying on business within their confines. In a celebrated case—that of the John Deere Plow Company—the Privy Council decided one mooted point at least—namely, that a federally-incorporated company has the right to sue in a provincial court. The question is so important that we will consider it in some detail.

Origin of Deere Plow Company Case.

The case in question arose by way of an appeal from the British Columbia Supreme Court in *John Deere Plow Company* vs. *Theodore Wharton and Garnet Duck*, with the Attorney-General for the Province and the Dominion intervening. The appellant company was incorporated in 1907 by letters patent issued under the Companies Act of the Dominion. The letters patent purported to authorize it to carry on throughout Canada the business of dealer in agricultural implements.

It was held by the court below—the supreme court of British Columbia—that certain provisions of the British Columbia Companies Act had been validly enacted by the provin-

cial legislature. These provisions prohibit companies which have not been incorporated under the law of the province from taking proceedings in the courts of the province in respect of contracts made within the province in course of their business, unless licensed under the Provincial Companies Act; they also impose penalties on the company and its agents if not having obtained license, it or they carry on the company's business in the province. The appellant was refused a license by the Registrar. It was said that there was already a company registered in the province under the same name. The question which has to be determined is whether the legislation of the province which imposed these prohibitions was valid under th British North Amrica Act.

As reference is made in the decision of the Privy Council to sections 91 and 92 of the British North America Act it will be necessary to state clearly, first of all, what is contained therein. The introductory clause of section 91 of the B. N. A. Act reads as follows:

"It shall be lawful for the Queen, by and with the advice and consent of the Senate and House of Commons, to make laws for the peace, order and good government of Canada, in relation to all matters not coming within the classes of subjects by this Act assigned exclusively to the legislatures of the provinces." Sub-section 2 of section 91 gives the Dominion the right to regulate trade and commerce in Canada; sub-section 10 gives the Dominion control over navigation and shipping; and sub-section 15 gives the Dominion control over banking, and the right to incorporate banks and to issue paper money.

The introductory clause of section 92 reads: "In each province the legislature may exclusively make laws in relation to matters coming within the classes of subjects hereinafter enumerated." The sub-sections under this clause mentioned in the decision of the Privy Council are: No. 11 which gives each province the right to incorporate companies with provincial objects, and No. 13, which gives the province jurisdiction over property and civil rights. Keeping these facts in mind we may now intelligently read the decision of the Privy Council.

Decision of Privy Council.

Their lordships had to decide whether it was competent to the province to legislate so as to interfere with carrying on of business in the province of a Dominion company under the circumstances stated. The distribution of powers under the British North America Act, said the Privy Council, interpretation of which is raised by this appeal, has been often discussed before judical committees and the tribunals of Canada, and certain principles are now well settled.

The general power conferred on the Dominion by section 91 to make laws for the peace, order and good government of Canada extends in terms only to matters not coming within the classes of subjects assigned by the act exclusively to the legislatures of the provinces, but if the subject matter falls within any of the heads of section 92, it becomes necessary to see whether it also falls within any of the enumerated heads of section 91, for if so, by the concluding words of that section, it is excluded from the powers conferred by section 92.

Expression "Civil Rights."

Turning to the appeal before them, the first observation their lordships make is that the power of the provincial legislature to make laws in relation to matters coming within the classes of subjects forming No. 11 of section 92, the incorporation of companies with provincial objects cannot extend to a company such as the appellant company, the objects of which are not provincial, nor is this defect of power aided by the power given by No. 13, relating to property and civil rights; unless these two heads are read disjunctively the limitation in No. 11 would be nugatory.

The expression "civil rights" in a province is a very wide one, extending, if interpreted literally, to much of the field of other heads of section 92 and also to much of the field of section 91. But the expression cannot be so interpreted and it must be regarded as excluding cases expressly dealt with elsewhere in the two sections notwithstanding the generality of words. If this be so, then the power of legislating with reference to the incorporation of companies with other than provincial objects must belong exclusively to the Dominion parliament, for the matter is one not coming within the classes of subjects assiggned exclusively to the legislatures of the provinces within the meaning of the initial words of section 91 and may be properly regarded as a matter affecting the Dominion generally and covered by the expression "the peace, order and good government of Canada."

It follows from these premises that those provisions of the Companies Act of British Columbia, which are relied on in the present case as compelling the appellant company to obtain provincial license of the kind about which controversy has arisen or to be registered in the province as a condition of exercising its powers or of suing in courts, are inoperative for these purposes. The question is not one or the enactment of laws affecting the general public in the province and relating to civil rights or taxation or administration of justice. It is in reality whether the province can interfere with the status and corporate capacity of a Dominion company in so far as

that status and capacity carries with it powers conferred by the parliament of Canada to carry on business in every part of the Dominion.

Their lordships are of the opinion this question must be answered in the negative.

They think the legislation in question really strikes at the capacities which are the natural and logical consequences of the incorporation by the Dominion government of companies with other than provincial objects. These appeals are allowed and judgment entered for the appellant company in the action of Wharton vs. John Deere Plow Company while costs of the action by the company against respondent Duck must, unless parties come to an agreement, be remitted to the court below to be disposed of in accordance with the result of this appeal. As to the interveners, the Attorney-General of the Dominion and Attorney-General of the province, there will be no order as regards costs. Respondents Wharton and Duck must pay the costs of appellant company's appeal, excepting so far as those increased by the interventions.

The Effect of the Decision.

The significance of the judgment is found in the sentence: "The question is not one of the enactment of laws affecting the general public in the province and relating to civil rights or taxation or administration of justice. It is in reality whether the province can interfere with the status and corporate capacity of a Dominion company in so far as that status and capacity carries with it powers conferred by the parliament of Canada to carry on business in every part of the Dominion. Their lordships are of the opinion that this question must be answered in the negative."

As the Privy Council says, the requiring of a license or the obligation of being registered in the province as conditions for a company's exercising its powers of suing in the courts, in the case of a federally-incorporated company, *is inoperative for this purpose.* That is to say, a province cannot deny the use of its courts to a corporation chartered by the federal government. But there are a great many things that a province can do with respect to such corporations. For one thing it may subject them to taxation. But just what jurisdiction or control the individual provinces have over Dominion corporations has yet, in large measure, to be decided by the courts.

> *The British North America Act, by means of which the Canadian provinces were federated, provided a working constitution for a country that was as yet, at least from an industrial point of view, in a primitive or pioneer state. While the Dominion*

was given an absolutely free hand in regulating interprovincial trade and commerce, yet the provinces and the Dominion are bound to clash at times on the question of their respective rights to regulate the industries of the country. The constitution of Canada remains fixed, and can be altered only by an Imperial act. But modern trade and industry tend to become more complex; and the courts should consider the needs of changing conditions when they attempt to interpret our fixed constitution.

Charter Powers of Provinces.

The same decision states: "The power of legislating with reference to the incorporation of companies with other than provincial objects must belong exclusively to Dominion parliament, for the matter is one not coming within the classes of subjects assigned exclusively to the legislatures of the provinces within the meaning of the initial words of section 91, and may properly be regarded as a matter affecting the Dominion generally and covered by the expression the peace, order and good government of Canada.'"

It will be recalled that sub-section No. 11 of section 92 states that the provinces may incorporate companies with provincial objects. The following points should be noted in connection with this provincial right:

(1) A Dominion statute creating a corporation to carry on business in the Dominion, is not an interference with this sub-section, even if the company confines its operations to one province only, and is valid.

(2) A company chartered to operate in one province, and operating there, is a provincial company.

(3) A company chartered to operate in several provinces and operating in only one is a Dominion company.

(4) The words, "provincial objects," refer to local objects within a province in contradistinction to objects which are common to all provinces in their collective or Dominion quality.

(5) A provincial act incorporating an insurance company is within this sub-section, and such company may enter into contracts outside the province of incorporation whenever such contracts are recognized by comity or otherwise.

(6) Such a company's contracts entered into outside the province of incorporation have only whatever force the authority in such place (outside the province of incorporation) chooses by comity, or otherwise, to accord them.

(7) Canadian statutes, rendering Canadians and Canadian corporations subject to any United States laws, are un-

constitutional, this being an abdication of sovereignty, and this sub-section cannot give them validity.

(8) A provincial act legislating respecting a provincial railway running only to the boundaries of the province is within the power of the province under this sub-section, even though there be corresponding legislation by the authority beyond the province providing for connection with it.

The important points to consider are as follows: The words "provincial objects"—as explained above—merely relate to the subject matter of legislation. The majority of the supreme court have upheld the contention that a provincial corporation may operate beyond the limits of a province provided that, by the "comity," or courtesy, of other provinces such a corporation is permitted to enter their borders to carry on its business. This, of course, by no means implies that a province can *empower* one of its corporations to carry on business beyond its own borders. This interpretation is wider than the one that has been sometimes held—namely, that the words "provincial objects,, imply a territorial limitation; that is, that the province can incorporate companies that shall carry on their business within the province alone.

Dominion Rights and Jurisdiction. Sub-section 2 of section 91 gives the Dominion the right to regulate trade and commerce. The main facts to be considered in this connection are as follows:

(1) This sub-section does not extend to the regulation of the contracts of a particular business in a single province.

(2) It does not prevent, as has been said, a provincial legislature from levying taxes on commercial corporations created by the Dominion Parliament. This is the case whether the institution is created by Imperial, Dominion, Provincial, Colonial or Foreign authority.

(3) Nor does the fact of such company having obtained a license from a Dominion officer before being allowed to carry on business in the Dominion (such a course being required by a Dominion statute, 38 V. C. 20) serve to withdraw the company from the operation of the Provincial Act.

(4) Legislation respecting trade and commerce must necessarily affect to some extent property and civil rights, over which the provincial legislatures have (section 92, sub-section 13), jurisdiction.

(5) The right to regulate trade and commerce is not to be overridden by any local legislation in reference to any subject over which power is given to the local legislature; and in such case the law of the local legislature must yield to that of the Dominion parliament.

(6) The power of the Dominion parliament under this sub-section includes control of political arrangements in regard to trade, and regulations of trade, in matters of interprovincial concern.

How companies are incorporated. In former days, in England, companies were incorporated by a separate grant from the king or from parliament. The method was obviously a cumbersome one, and in time it gave way to incorporation by Letters Patent and by special act. Today, the general rule in the United Kingdom, the United States and Canada, is to incorporate companies under the terms of a general act; although corporations formed for the construction and working of railways, of telegraph or telephone lines, and those formed for the purpose of carrying on the business of loan companies, banks and insurance societies, are created by special act either of the Dominion parliament or of the provincial legislatures. As has been pointed out already the provinces cannot empower companies to carry on business beyond their borders. Whenever a provincially-incorporated company does so it is, as has been said, merely by the operation of the principle of comity—that is, through the explicit or implied permission of the other provinces. It should be observed that the Dominion alone has the right to grant a charter to a bank. It is plain, too, why railways, banks, insurance and loan companies must receive their charters direct from the federal parliament or the provincial legislatures. They are quasi-public institutions upon whose success or failure the well-being of the community depends.

Application for Incorporation.

The Dominion Companies Act of 1906 provides that the Secretary of State may grant a charter to any number of persons, not less than five, who apply for such and who are prospective shareholders in the new concern. The applicants for letters patent, who must be twenty-one years of age, are required in their application to furnish the Department of the Secretary of State the following particulars:

(a) The name of the company; in choosing which wide latitude is usually allowed, the principal restriction being the prohibition of names like, or nearly like, those of corporations already incorporated and doing business. Under the Dominion Companies Act it is required that "Limited" be the last word in the name.

(b) The purposes for which its incorporation is sought.

(c) The place within Canada which is to be its chief place of business.

(d) The proposed amount of its capital stock. The capitalization of the company, as specified in the application, may be changed thereafter only by amendment of the charter. There is no maximum limit to capitalization, though New Brunswick has a minimum of $2,000, and Prince Edward Island a minimum of $500.

(e) The number of shares and the amount of each share. The par value of shares may be fixed by the incorporators at their discretion. One hundred dollars is the most convenient and most generally adopted par value for shares of stock. Mining companies and others of a speculative nature frequently issue shares as low in value as one dollar, and shares of par value of ten dollars are common.

(f) The names in full and the addresses and calling of each of the applicants, with special mention of the names of not more than fifteen, and not less than three, of their number, who are to be the first or provisional directors of the company. Frequently these provisional directors are purely nominal or "dummy." A review of the report of the Secretary of State shows that they are often law clerks and stenographers in the offices where the applications are prepared.

(g) The amount of stock taken by each applicant; the amount, if any, paid in upon the stock of each applicant; the manner in which the same has been paid and is held by the company.

The Act permits the Secretary of State to give the company a corporate name, different from that proposed by the applicants, if the proposed name is objectionable.

It is required that notice of the granting of letters patent shall be given by the Secretary of State by two insertions in the Canada Gazette, after which the subscribers to the memorandum agreement, and their successors, shall be duly incorporated.

It is further required that a copy of such notice shall be by the company to which such notice relates, inserted on four separate occasions in at least one newspaper in the county, city or place where the head office or chief agency of the company is established.

The Governor-General-in-Council may from time to time alter and regulate the tariff of fees to be paid on application for any letters patent or supplementary letters patent, the amount of which may be varied according to the nature of the company, the amount of the capital stock or other particulars, and no steps may be taken towards the issue of any letters patent until after all fees are duly paid.

The company is not permitted to commence its operations, or incur any liability, before ten per cent. of its authorized capital has been subscribed and paid for.

The Act requires every prospectus of the company and every notice inviting persons to subscribe for shares in the company to specify the date, and the names of the parties to any contract entered into by the company or the promoters, directors or trustees thereof, before the issue of such prospectus or notice, whether subject to the adoption by the directors or the company, and any prospectus which does not suecify such names and dates shall be deemed fraudulent on the part of the officers of the company who knowingly issue it.

When not specifically stated by the letters patent, the stock shall be allotted at such times, and in such manner, as the directors may prescribe. They may issue any part of the capital stock as preference stock, giving the same such preference and priority as respects dividends, and in any other respect, over common stock, as they may deem expedient.

It is also provided that the holders of preference stock may be given the right to select a certain stated proposition of the board of directors or such other control over the affairs of the company as may be considered expedient.

Provincial Charters.

The provincial Companies Acts agree with each other, and with the Dominion Act, in all essentials, so that the procedure under them is very similar to that followed when a federal charter is sought. None save Manitoba has made any attempt to prevent flagrant over-capitalization and consequent swindling of investors. The Manitoba Act provides, in the words of the Act, that where "any advertisement, letter head, postal card, account or document, issued, published or circiulated by any corporation, association or company, or any officer, agent or employee of any such corporation, association or company, purports to state the subscribed capital so actually and in good faith subscribed as aforesald, or which contains any untrue or false statement as to the incorporation, control, supervision, management or financial standing of such corporation, association or company, and which statement is intended or calculated or likely to mislead or deceive any person dealing or having any business or transaction, with said corporation or company . . . shall . . be liable to a penalty not exceeding two hundred dollars and costs and not less than fifty dollars and costs."

It is further provided that the Lieutenant-Governor-in-Council may appoint inspectors for the purpose of examining into the affairs of any corporation upon the application of members holding not less than one-fifth of all shares issued, or, in case it appear that in the interests of justice an inspection

should he made, then upon the application of any one having, or clalmlng to have, any Interest in the company.

The Act requires offlcers and agents of the company to produce for examination all books and documents In thelr control, and permits the inspector to examine, under oath, the officers and agents, or any director or shareholder, of the company.

The inspector or inspectors, upon the conclusion of the examination, report to the Lieutenant-Governor-in-Council, who directs by whom, and in what manner, the costs of the inquiry shall be paid.

Provision is made for the appointment of counsel by the Lieutenant-Governor-ln-Council to advise and act with the inspectors. And the concluding clause of the act permits any one to be prosecutor or complainant and provides that one-half of any fine imposed shall belong to His Majesty, for the use of the Province, and the other half to the prosecutor or complainant.

Blue Sky Legislation in the United States.

In the United States the Blue Sky Act of 1911 passed by the Kansas legislature has been widely imitated, and in 1913 about thirty states of the Union introduced Blue Sky bills to regulate the sale of securities.

The Kansas Act provides that an investment company shall file "an itemized account of its actual financial condition and such other information concerning its affairs as sald bank commissioner may require," and, again, it shall be the duty of the bank commissioner to examine the statements and documents so filed ,and if said bank commissioner shall deem it advisahle, he shall make, or have made, a detailed examination of such investment company's affairs, which examination shall be at the expense of such investment company." A provision even more extreme requires that "all . . books and accounts . . . shall at all times during husiness hours be open to inspection of stock holders and investors in said company, or investors in the stocks, honds or other securities by it offered for sale, and to the bank commissioner and his deputies."

Although many state legislatures have adopted bills which are the direct descendants of the Kansas Act, yet It would appear that It has not been altogether satisfactory in so much as it unnecessarily hampers the investment banker, and leads to a confusion of ideas because it fails to distinguish between what an investor is entitled to look for in the corporation issuing the securities he is buying, and what he ls entitled to look for from the promoter, banker or dealer, who sells him the securities. However, It is a step in the right direction and

Canada will, sooner or later, probably adopt some similar method of regulating the capitalization of companies and the sale of fraudulent securities to orphans, widows and others who are not in a position to judge for themselves.

The by-laws of a corporation. As has been explained a corporation's powers are limited by the general law and by the terms of its charter. Concerning such powers the business world is easily informed, but the same cannot be said of the rules and regulations—the by-laws—which govern its private affairs. A company may make by-laws which do not run counter to the general law or the special terms under which its charter has been granted. It may, for example, regulate the allotment, payment and forfeiture of stock; the declaration and payment of dividends; the amount of stock qualifications of its directors and their remuneration. It may provide for the appointment, functions, duties and remuneration, as well as the removal of all agents, officers and servants of the company; the calling of meetings and the procedure thereat; and, generally, "the conduct, in all other particulars, of the affairs of the company." (Section 44 of the Companies Act.) A by-law must operate in a reasonable way—that is, it must not work unequally toward members of any class affected by it. If a by-law, for example, discriminates as to terms of payment of stock between certain individuals and other stockholders, it is invalid. (The North-West Electric Co. vs. Walsh, 29 S.C.R., 33). And, finally, the by-laws may be altered or added to from time to time; but not in such a way as to permit a fraud upon a minority.

A careful distinction should be made between a by-law and a resolution. The latter is adopted ordinarily for special matters, as the appointment of an agent, the publication of notices, the policy of the company, the making of calls. A by-law, on the contrary, is intended to operate generally; and is used to provide for the general regulation of the company's affairs.

A resolution may be submitted to a general meeting of stockholders by the chairman or by any stockholder. The directors also conduct their business by resolution. The following list furnishes a general idea of the matters concerning which by-laws are passed:

1. Location of head office.
2. Adoption of a seal.
3. The dates upon which the financial year shall begin and end.
4. Conditions under which a special general meeting of the corporation shall be called.
5. Notice of time and place of the general annual meeting.

6. The number of shareholders, and the value of the stock represented, necessary to form a quorum for an annual meeting.

7. Terms of voting; provision for proxies.

8. Appointment of directors; their terms of office.

9. Powers of directors. An example of the powers granted to the directors by a typical corporation is found in the following:—

The directors may, from time to time, make by-laws not contrary to law or to the Letters Patent incorporating the Company, to regulate:

(a) The allotment of stock; the making of calls; the issue and registration of certificates of stock; the forfeiture of stock for non-payment; the disposal of forfeited stock and of the proceeds thereof; and the transfer of stock.

(b) The declaration and payment of dividends.

(c) The appointment, functions, duties and removal of all officers, agents and servants of the Company, and their remuneration.

(d) The time at which, and the place where, meetings of the Board of Directors and of the Company shall be held; the quorum; the requirements as to proxies; and the proceedings at all such meetings.

(e) The conduct in all other particulars of the affairs of the Company.

12. Meetings of directors—general and special.

13. Method of voting at meetings of directors.

14. Payment of directors.

15. Choosing officers of the corporation.

16. Duties of officers.

17. Salaries to be paid to officers and employees of the company.

18. Change of by-laws. The powers granted to the directors under this head are often very wide, as an example will show:

The Board of Directors may from time to time repeal, amend and re-enact the by-laws, but such change, unless in the meantime confirmed at a general meeting of shareholders, duly called for that purpose, shall have force only until the next annual meeting of the Company; and, if not confirmed thereat, shall from that time cease to have any force or effect.

20. Auditing of the accounts of the corporation.

21. Cheques, etc. A typical by-law covering this feature of a company's business follows:

The president or the vice-president may endorse for deposit all bills of exchange, cheques and promissory notes in the name and on behalf of the Company.

All cheques, promissory notes or orders for the payment of moneys by the Company shall be made and signed on behalf of the Company by the president and be countersigned by another director, who may be the vice-president.

22. Stock book and stock certificates.

23. Transfers.

24. Incorporation of Company. The following is a typical by-law under this head:

The directors may adopt and ratify any contracts entered into on behalf of the Company by the organizers or promoters thereof or any of them, and are hereby authorized and directed to pay all necessary and reasonable costs and expenses in any way incurred in connection with the promotion, incorporation and organization of the Company.

25. Allotment of stock.

26. Reserve. The following may serve as an example of the method of handling the reserve:

Before payment of any dividend or distribution of profits there may be set aside out of the net profits of the Company such sum or sums as the directors may from time to time, in their absolute discretion, think proper, as a reserve fund, for any purpose which the directors may think is in the interests of the Company.

27. Banking. The following is a typical by-law with respect to the banking business of a corporation:

The directors are hereby authorized from time to time:

(a) To borrow any sum or sums from the ..... Bank, or from any other person or corporation whatsoever, upon the credit of the Company, either by way of overdraft, discount, loan, or otherwise, and on such terms as they may think proper, and to hypothecate, mortgage, pledge, and give to the said lender all or any stocks, bonds, debentures, negotiable instruments, agreements to supply securities and all other agreements, securities and documents necessary or required by or on behalf of the said lender in respect of all advances and liabilities now or hereafter existing, and also without limitation of the foregoing, to hypothecate, give, pledge and grant to the said lender warehouse receipts, bills of lading, assignments, securities and promises and agreements to give security, under the Companies Act or the Bank Act, and for any of the purposes aforesaid to mortgage, hypothecate and pledge the movable and immovable property of the Company.

(b) To authorize from time to time, by resolution or by-law, such director or directors, officer or officers; clerk, cashier or other employee of the Company, as the directors appoint, to transact its business with the said Bank, and to sign and execute on behalf of the Company all such cheques, promissory notes and negotiable instruments, documents, agreements, se-

curities, promises and pledges as aforesaid, and to delegate in and by resolution or by-law to such person the powers hereby conferred upon the directors.

And further, that this by-law shall continue in full force, virtue and effect as between the Company and the said Bank, until notice of the revocation of cancellation thereof be given to the said Bank in writing.

Ultra vires acts. It should be observed that companies incorporated under the various companies acts have broad general or "ancillary" powers. A corporation, under the Dominion Companies Act, forthwith becomes vested with all the powers, privileges and immunities requisite or incidental to the carrying on of its business. As a result a company may carry on any business as an adjunct which may prove convenient or advantageous to it. Its powers are limited by its charter and the general law; that is, whatever its charter may be the general powers conferred under the Companies Act are not denied it. Nevertheless, wide as are the powers of various companies acts, they may not be found wide enough to cover all the kinds of business in which the company may desire to engage. It is absolutely essential to state in the petition any desired powers which are not mentioned in or are denied by the companies act. The Dominion Act, for example, forbids a company to use its funds to buy stock in any other corporation until a by-law for that purpose has been sanctioned by a vote of not less than two-thirds in value of the capital stock represented at a special meeting of the company called for the purpose. If the company's charter authorizes such a transaction, however, it is not necessary to pass such a by-law.

An *ultra vires* act is one which is not within the powers directly or indirectly conferred upon the company. It follows that contracts for ends foreign to, or inconsistent with, the powers of the company are *ultra vires.* On the other hand, acts are not *ultra vires* which may be regarded, reasonably, as incidental to a company's objects and powers. It follows that not even the consent of the shareholders can validate an *ultra vires* act. Mr. W. S. Johnson in his work on "Commercial Law" says:

"The issuance of stock at a discount, the payment of dividends out of capital, and the purchasing of a company's own shares, or shares of another company, are all held by law to be *ultra vires.* Another example was furnished by English courts which held that it was *ultra vires* for a company, unless it was specially authorized, to take over the undertaking of another company. It has been held by the Privy Council that an *ultra vires* act is not validated where a company consents to a judgment which orders the doing of such an act."

As has been said, a corporation is limited in its action, and enjoys only such rights as are specifically given it, by (a) the constitution of Canada and general legislation; (b) the companies act under which it is incorporated; (c) its charter; and (d) its by-laws. Certain corporations can not begin business by grant of letters patent under a general companies act; they must receive their charters directly from a provincial legislature or from the Dominion parliament. Companies having "provincial objects" may be granted charters by the provinces; all others must go to the Dominion. It should be noted that the Dominion alone can grant a charter to a bank, even although the bank in question wished to conduct a purely provincial business. Companies other than those enumerated —banks, railways, insurance companies, etc.—may receive their charters under the provisions of a general companies act.

Questions for Review.

1. Name the four instruments which limit the powers of a corporation.
2. State clearly the substance of the decision of the Privy Council in the John Deere Plow Company case.
3. Why should a province be restrained from refusing the use of its courts to federally-incorporated companies?
4. Name the specific rights of a province in granting charters to corporations.
5. Explain what is meant by the principle of "comity" under which a provincial corporation may carry on business in another province.
6. Why should certain corporations—such as banks, insurance companies, railway companies, etc.—be obliged to go to the Dominion parliament or to the local legislatures to receive their charters while other corporations can get their charters by letters patent under the various companies acts?
7. Explain what is meant by the right of the several provinces to incorporate companies having "provincial objects."
8. Can a province *empower* one of its own companies to transact business elsewhere?
9. State the particulars that must accompany an application to the Secretary of State for letters patent.
10. What is meant by "Blue Sky" legislation? To what extent has it been adopted in Canada?
11. When may a corporation begin business, after having received its charter?

12. What are the by-laws of a corporation? Who generally pass them?

13. Must by-laws treat all shareholders equally and alike?

14. What is the difference between a "resolution" and a by-law?

15. What forms the general subject-matter of the by-laws of ordinary corporations?

16. What body authorizes the officials of a corporation to carry on the banking business of the company?

16. What are "ultra vires" acts of a corporation?

Questions for Written Answer.

17. To what extent are the powers of directors limited by by-law? Why are directors themselves permitted to pass by-laws? Under what conditions may they do so?

18. What kinds of corporations may the Dominion incorporate? What is the extent of the powers of the several provinces to incorporate companies?

19. State clearly how you would proceed to incorporate any kind of manufacturing concern, and what points you would cover in your application for letters patent.

20. Bring up any difficulties.

LESSON III.

Corporate Stock Issues; Types of Business Corporations.

Should stock certificates be negotiable? Stock certificates are *rights, not tangible property.* They merely give the legal hoider the right to share, to a more or less limited extent, in the management and the earnings of the corporation. Stock certificates in themselves are not proof, but merely evidence, of the ownership of stock. The books of the concern themselves furnish the proof as to the actual ownership of stock, because in them the names of the shareholders and the number of shares held by each one are entered. Certificates of stock are, therefore, strictly speaking, not negotiable, but quasi-negotiabie. If transfer of ownership of stock were complete on deiivery of endorsed certificates of stock without waiting for the formal transfer on the books of the corporation the stock would be freely negotiable; and such procedure has been advocated in some quarters. A writer in the "Journal of Accounting" has said, concerning this proposal:

"The change wouid no doubt faciiitate somewhat the purchase and saie of stock by removing the technical requirement that the transfers must be made on the books of the corporation. It would enable the stock exchange brokers to carry on their business more easily and more smoothiy. It would make stock certificates more acceptabie to banks as collateral for ioans. These are the strongest arguments in favor of the act (an act suggested by the Commission on Uniform State Laws, in the United States). On the other side of the question it should be remarked that making certificates of stock fuliy negotiable subjects them to increased danger of forgery, theft and ioss. Many people, no doubt, would prefer the comparative safety of the present system, just as many investors, when a choice is offered, take registered rather than coupon bonds. This is a point of considerabie importance. A far stronger argument against the proposed measure, however, is that it would destroy the value of the corporation's record of its stockhoiders, and wouid thereby foster fraud. Accountants are oniy too familiar with cases in which corporations are organized simpiy for the purpose of transferring roperty from one hand to another in such a manner as to cancei profits or to swindie creditors. Under the present arrangement it is generaiiy possible, if fraud is suspected, to get access to the stockhoiders' ledger and to iearn who are the owners of the corporation. If a connection between the former owners of the transferred property and the sharehoiders of the corporation can

be proven, a case of fraud may be made out. Under the proposed arrangement it would be impossible to discover the true owners of such a corporation. The stockholders' ledger, indeed, might be kept, but it would be of small value. The certificates of stock, and consequently the ownership of the corporation, might change hands a half a dozen times without appearing on the corporation's books. Numerous similar cases will occur to any accountant."

This puts the case admirably, and shows the underlying reasons why stock certificates are not freely negotiable instruments.

The par value of stock. Each share of stock has a nominal or "par" value, as distinct from its market value. The most comon nominal value of each share is $100; others in common use are $50, $25, $10 and $1. The market value and the par value, it need hardly be said, have nothing in common. Par values, are in a sense, without importance, as can be seen from the following illustration: Let us suppose that two silver mines are discovered of equal value as to location and so forth, and of equal earning capacity. One promoter might capitalize his mine at $100,000 in 10,000 shares having a par value of $10 each. The second promoter may have a more vivid imagination, may be more optimistic and sanguine concerning the actual value of his property; he therefore capitalizes his mine at $1,000,000 in 10,000 shares at $100 each. Now what will be the actual value of a single share in each of these two companies? Each share entitles the holder to 1-10,000 part of the assets and earnings of the mine. As, according to our hypothesis, the mines are equally profitable and equally valuable there will be no difference between the actual market values of the shares.

These useless par value might be eliminated, and each share be given a right to a certain percentage of the assets and earnings of the corporation in question. In other words instead of saying that a corporation has a capital stock of $1,000.000 made up of shares whose par value is $100, it might be said, instead, that the company had 10,000 shares of stock outstanding. Logically there can be no objection to such a proposal: and misconceptions based upon the idea that par value and market value in some way correspond, are avoided. However, there is no widespread demand for such a change; although, in the United States, the State of New York has legalized the practice.

Preferred and common stock. When all the stock of a corporation is of one class and each share has a right to an equal proportion of the assets and earnings the stock is called "common," because no share has any privileges that do not

attach to all the other shares. We may therefore define common stock as stock which does not possess any special or peculiar rights.

Many corporations, however, set aside certain amounts of stock in a separate class and grant to such stock special privileges. These shares then become preferred stock. Usually the special advantage given to this stock consists in giving it a fixed dividend before anything whatever is paid to the common stock. This dividend becomes "cumulative" if for any reason a dividend is passed in any year and back payments are made good before anything is paid on the common stock. It is a "non-cumulative" preferred stock when back dividends that have been passed are not paid in future years no matter how large the earnings may be. But the preference as to the dividends is merely the comon, not the universal privilege, granted to preferred stock. It is necessary to consult the charter and by-laws of the corporation to discover the exact nature of the preference granted to this type of stock.

For example, it may be found that the stock may carry with it a preference as to assets, as well as the dividends. Then again, cumulative preferred stock may get a fixed dividend and nothing more. This is the customary arrangement; but it may also participate equally with the common stock in excess earnings after the latter has received a fixed rate; or the preferred stock may get a fixed dividend and after the comon stock has received its fixed return the balance may go entirely to the preferred stockholders. This is a very common arrangement.

Prefered stock had its origin in the United States through railroad reorganizations. In such cases it was found after a railroad had been declared bankrupt it was necessary to scale down the fixed charges in the shape of bond interest. In that case the "junior" bonds were exchanged for preferred stock—that is, the second-mortgage bonds were exchanged for securities, the interest on which had not to be necessarily paid, but which, nevertheless, received the first dividend after all fixed charges had been met. The railroad companies, it may be said in passing, are now giving up this method of financlal reorganization.

(*Continued in next Bulletin*).