

## CHAPTER XII

### The Corporation

THE HISTORY AND OBJECTS OF THE CORPORATION AND THE  
TAXING AND REGULATION OF CORPORATE BUSINESS.

*A corporation cannot blush. It is a body, it is true; has certainly a head—a new one every year; arms it has and very long ones for it can reach at anything . . . a throat to swallow the rights of the community, and a stomach to digest them! But who ever yet discovered, in the anatomy of a corporation, either bowels or heart?*

—HOWEL WALSH

**B**EFORE going further it may be well to say a word about the corporation, for inflation and the changing of values which it brings affect vitally the owners of incorporated business.

What is a corporation? It has been defined as an artificial or fictitious person created by law, but this is far from satisfactory. Law cannot create a person, and the corporation lacks every attribute of personality, although it does possess many of the rights of the individual. A better definition is that a corporation is an association of persons authorized to act as a single person in business affairs.

There are three ways in which business may be done. A man may set up for himself and operate purely as an individual, as do many farmers, small shop-keepers, and craftsmen, practically merging business with personal affairs. The writer's grandfather followed this course more than a century ago, not taking the trouble to disentangle personal affairs from his business. He made money and did well. There was no income tax to harass him, and he was satisfied to know that his family was living in comfort and his children were well educated. He owned a good house in a good neighborhood and had money on hand for all reasonable needs. This individualistic way of doing business is of course the simplest way, but it is scarcely wise for most of us today, and the exacting demands of the income tax compel us to unscramble the bookkeeping of business from that of family affairs.

The next step is the partnership, when two or more persons join in an enterprise in any relationship other than as employer and employee. The nature of partnerships, the numbers joining

in such operations, the relations of individuals, and the proportionate share of investment, responsibility and profits, are susceptible of endless variations. Partnership agreements should be drawn by a competent lawyer and studied with the utmost care, for this form of business may involve very serious hazards.

In a partnership each individual partner may be responsible for all the obligations of the partnership, for any engagements entered into and obligations incurred. Not only is there a possibility of broad personal liberty in partnership affairs, but, under some circumstances, one partner may be held for the debts and obligations incurred by other partners, even those of a personal nature disassociated from the partnership relation. Partnerships must generally be dissolved on the death of any partner, and it is often extremely hazardous for a widow to continue as a partner in the firm of her late husband.

Obviously a partnership would be an impossible form of organization for a great industry such as a railroad, the public utilities, and the great manufacturing concerns. The American Telephone & Telegraph Company has nearly a million and a half owners, virtually partners, but it would be utterly out of the question for such numbers to unite in a partnership. The answer is a corporation. It can own, buy, and sell property; it can sue and be sued; it can enter into contractual relations and incur all sorts of obligations; it may do almost anything which a private individual or partnership can do, as far as business is concerned. Its existence is not disturbed by the death of any of the stockholders. The interest of each stockholder can be sold or bequeathed to others and this makes for a flexibility of membership impossible in the partnership. Furthermore, and this is very important, there is a limit on the liability of its owners, for the corporation must fulfill its own contracts and pay its own bills. The personal property of the individual stockholders is not liable for its debts under ordinary circumstances, except in the case of national banks where stockholders may be subject to assessment.

These are some of the points in which a corporation resembles the individual, but what is more important are the points in which it differs from the individual. It is all very well to talk about an artificial person, but man's laws cannot create a human consciousness or a true personality. The corporation must remain a legal convenience, and, although it may act as a unit in business, the personalities of the individuals cannot be adsorbed in a legal entity.

Coke, the English jurist, said more than three hundred years

ago, "Corporations cannot commit treason, nor be outlawed, nor excommunicated, for they have no souls." Conscience and the faculty of being pleased or being punished are always personal, and, as has been well said, "Guilt is always personal." A corporation cannot be imprisoned; it can't suffer, and, if put to death by legal annulment or penalized, it is the individuals who own it who suffer. A corporation has "neither a body to be kicked nor a soul to be damned," and it is generally folly to tax the earnings of a corporation, for although taxes come out of its treasury, it is the stockholders who actually pay. It is part of their income that is taken. But more will be said on this when we come to the question of taxation.

Without the corporation we could have no great businesses nor could we engage in any big undertakings. No partnership arrangement could make it possible for thousands, hundreds of thousands, and in one case well over a million persons to unite in a business enterprise. Under a partnership, dissolution is practically necessary on the death of any partner; as partnerships, our great corporations would be doing nothing but reorganizing, and it would be practically impossible to sell one's interest or to buy into it. This provision for flexibility of ownership is important and makes the corporation of tremendous benefit to persons of modest means who are thereby enabled to share in "big business." Practically the corporation provides the advantages and benefits of something like socialism but without the objectionable features. It effects a broad community of ownership in business, but, unlike socialism and communism, it is built on absolute respect for property rights, and it operates as private enterprise and not under political domination.

The business corporation as we know it, although not a new thing, developed greatly during the Elizabethan days in England. The early corporations often resembled partnerships: the number of shareholders were expected to take a part in the conduct of the business, ownership being frequently divided into sixteenths. As time passed, and because of the development of shipping, exploration and colonizing, opportunities for profitable investment expanded and the number of investors increased. In the seventeenth and eighteenth century East India companies were chartered in eight European countries to exploit the wealth of the Orient, the English company being chartered by Elizabeth the last day of the year 1600. There were originally a hundred and twenty-five stockholders and a capital of seventy-thousand pounds. The company was granted a monopoly of the trade with

the Orient and capitalization was expanded by the sale of the equivalent of eight million dollars worth of securities among a thousand stockholders. The first dividend paid was 87½ percent—not at all bad! It was probably because of the enormous success of some such companies that this business of promoting stock companies soon fell into the hands of swindlers who often robbed the gullible just as they sometimes do today.

With corporations a vital part of economic life and serving the common good, they should be encouraged and furthered by the government. They are always the creation of government, for a group of individuals cannot call themselves a corporation without warrant to incorporate, which is a privilege and not a natural right. Although the chartering of corporations should not be made difficult or needlessly expensive, conditions and limitations may be imposed as seem best. The government therefore is justified in maintaining some degree of regulation and control, and those seeking a charter can "take it or leave it."

The ownership of a corporation is evidenced by capital stock divided into shares, sometimes of fixed monetary value, sometimes representing only a proportion of the total. This stock may be bought and sold, the unit of transactions being the share. Transfer of the stock is transfer of ownership in the business and is evidenced by the stock certificate, registered on the books of the company. Ownership of stock commonly carries with it no obligation for debts of the corporation. The business and its profits are the property of stockholders; and profits, if there are any, are divided among them in dividends, paid as determined by the board of directors.

Often stock is of two kinds, common and preferred, the latter having first claim on earnings up to a certain point and usually a prior claim on assets in the event of dissolution. Sometimes stock is split into many classes. Usually preferred stockholders receive dividends at a fixed rate before the common receives anything, the remainder, regardless of amount, going to holders of common stock; therefore common may be worth more than the preferred. Sometimes, after dividends are paid on the preferred, earnings may be shared by both classes, such preferred being called participating preferred. If preferred is cumulative, it means that all back dividends remaining unpaid must be paid in full before any dividends are paid on the common; if non-cumulative, dividends are paid only if earned each year, and, if not earned in any year, they lapse. Sometimes preferred stock is convertible into common on certain terms and usually within



limited periods, giving owners opportunity to exchange their stock if profits of the business make it a wise course.

The set-up of a company may be far more complicated with many classes of stock, carrying varied claims and rights; and sometimes we find what is called a preference stock or a participating preferred intermediate in position between preferred and common.

A corporation is operated and administered by a board of directors elected to represent the stockholders, each stockholder having one vote for every share of "voting stock" held. Voting may be restricted to certain classes, often to common, with a provision that preferred may vote if its dividends remain unpaid. Corporations, like individuals, may borrow money; and often a large part of the financing is by bond issues, sold by "underwriters," generally recognized stock-brokers or "investment bankers." Essentially bonds are promises to repay a loan at a fixed date, with interest, usually semi-annually, sometimes paid by check to registered owners but more often on presentation of interest coupons attached to the bonds, specifying the amount of interest and the date due. Registered bonds are transferable only on the books of the company while coupon bonds are free from that formality, mere ownership evidencing title. The former are safer from hazards of loss or theft but more troublesome to sell or transfer.

Bonds may be secured in various ways; if unsecured, and no more than the promise of the corporation, they are called debentures. Mortgage bonds are secured by a mortgage to a trustee who is supposed to watch over the interests of bond-holders. Unfortunately the trustee—often a bank closely affiliated with the management of the company—frequently serves two masters, and the bond-holder may find the fancied guarantee largely illusory. There are collateral bonds, secured by property deposited with a trustee as security, much as a watch is left with a pawnbroker; refunding bonds to be exchanged for existing bonds or sold to pay them; convertible bonds, which may be exchanged for stock; and indeed there are so many classes that the buyer will do well to study them carefully. In principle, however, they are all alike, being loans of a definite amount with a fixed interest and usually having no other claims or rights.

At some periods in our history investors have been alarmed at the prospect of inflation or devaluation of our currency. This was notably true during the free silver period. Bondholders sought protection from any scheme which meant that the dollars

which they had loaned might be repaid in dollars of lesser value; so the borrowers assumed these risks. They stipulated that all payments of interest or of principal were to be repaid in "gold coin of the present standard of weight and fineness." This clause was inserted for the very purpose of protecting holders from just what happened in 1932 when the President announced the repudiation of this contract in government bonds. With the Supreme Court sustaining such action and holding that these solemn pledges were not binding, private borrowers followed the example of the government; and bond-holders found themselves compelled to accept payments in fifty-nine-cent dollars, not of gold, despite the promise upon which they had relied for protection in this very situation.

Probably the only classes pretty sure to profit from devaluation programs are the two extremes of the social ladder: those whose debts exceed their assets, but who hope someday to discharge their obligations, and the wealthy, represented conspicuously by owners of common stock in corporations which have heavy bonded indebtedness. By paying off the bonds in debased currency, the value of their stocks is materially increased through elimination of the prior claims of bond-holders. Thus stockholders profit at the expense of bond-holders, but the owners of these bonds are not necessarily wealthy people, for many are owned by persons of modest means.

Probably these stockholders are the ones who stand to benefit the most, for generally the propertyless man gives little thought to his debts, whereas the wealthy man profits enormously if he can pay off his loans in debased money. It looks as if many wealthy interests had profited by our devalued dollar. Particularly profitable is a policy of inflation to promoters financing operations with borrowed money, bonds furnishing all the funds while the stock is retained by the promoter. Obviously any program legalizing the discharge of such debt in depreciated dollars will react to the injury of the bond-holders and to the benefit of the stockholders, who receive their stock sometimes gratis as a bonus.

A computation of the indebtedness of one great corporation shows that, should inflation progress to the point where their bonds could be paid in all but worthless dollars, their common stock would show an enhancement in value of about sixty percent; and, should they see fit to call their whole issue of preferred stock, paying for that too in almost worthless money, the value of the common stock would be more than doubled. The bondholding class, which suffers, generally represents a greater

proportion of people with modest means than do the stockholders, and life insurance and savings-bank accounts may be wiped out.

Stocks and bonds are commonly sold on the stock exchanges, although they may be dealt in "over the counter." To detail the operation of such exchanges has no place here, but they serve an essential place in economic life, bringing buyers and sellers together and making a regular market for securities. Fortunately, through the action of brokers and stock exchanges as well as by governmental supervision, most of the oldtime abuses have been abated.

Losing sight of our fundamental purpose in the creation of corporations, many have become so involved in their structure that they have departed from the plan originally devised and are complex in the extreme. We find one company owning the stock of others; and, what is more confusing, they sometimes own each other's stock, so scrambling affairs that it is hard to get a clear view of the situation. There are companies within companies, interlocking companies, subsidiary companies and endless ramifications and interminable involvements of stocks and bonds. One company has three classes of common stocks with different rights, six classes of preferred, four classes of preference stock, seven issues of "secured"—more or less!—bonds and notes, twenty-four classes of debentures and four kinds of investment certificates, whatever they may be. Another company lists over fifty subsidiary companies, which they own in part or in whole; and many of these own as many as fifteen "sub-subsidiaries," some of these again divided into a half a dozen of their minor spawn.

To seek to know what is going on in such a mess is hopeless, and the way is opened to all kinds of frauds; stocks are manipulated, books juggled, and one company may be bled for the benefit of others owned by insiders. Frequently the same directors serve a dozen companies, often associated or having dealings with each other; and, even if there is little or no actual thievery, it is impossible to know what is going on. A common practice is to saddle all indebtedness on subsidiaries and then, representing the parent company as without debt, although it may be at the same time without any property of real value, owning only "watered stock," to give a very misleading picture of the situation.

The expression "watered stock," by which we mean stock which represents no actual cash investment and which is nothing more than dilution of the money invested by others, had origin in a trick of old Daniel Drew, who was a drover before he be-

came a "financier." He was in the habit of heavily salting cattle and then watering them copiously just before taking them to market, thus getting paid for the water the poor beasts drank. An example of watered stock is found in corporations which raise their entire capital by the sale of bonds and stock issued to promoters and insiders, stock which represents nothing whatever except uncertain prospects of dividends on this watery "capital." Companies have also been financed solely by the sale of preferred stock, some of the common being given as a bonus with the preferred and the rest sticking to the fingers of the promoters. Obviously such preferred stock has little claim to that designation.

As public policy the regulation of corporations should not be too exacting or too narrow. However, some corporations, notably those which we call public service corporations, enjoying special privileges or franchises and providing essential services for all our people, are of a nature necessitating a broad measure of control. Public service corporations generally have the right to take land by condemnation. Railroads, for instance, can take almost any land necessary for their purpose; and, if a satisfactory sale is not negotiated, an owner must accept the price set by the court. Public service corporations are frequently granted an exclusive franchise to use highways, streets, and other facilities: broadcasting companies enjoy special privileges over the air, and experience dictates that generally it is better to give one company the exclusive right to do some things, such as to supply gas to a city. If a company is given special privileges or a monopoly, it is only right that rates should be controlled and regulated and that there should be insistence upon service and uniform rates to all, to prevent exploitation of the public. Therefore, public service corporations are in a class by themselves.

The regulation of public service corporations is far from easy. In general terms, such a company should be required to render adequate service at a fair price, and to all the public on the same terms and at the same rate for comparable service with no discrimination. It is easy to say that rates should be fair, but it is not always easy to say just what is fair. The owners of the company, who supply necessary capital and shoulder responsibility should receive a just return, but how is this to be computed? It might be said that the return should be at the prevailing rate of interest on the amount invested; but such a policy, especially in these days of inflation, will not be fair either to the owners or to the public.

In nearly every business there is rapid depreciation of capital

and necessity for its replacement, sometimes as a result of natural wear and tear but often occasioned by the development of new processes and a demand for betterment of service. Railroad trains are far heavier, faster, and more comfortable; tracks and rights of way must be improved; and coal-burning locomotives must be replaced by diesels. All this calls for a constant renewal of capital, reinvestment and enlarged investment, and companies should be allowed earnings to pay not only fair dividends but to build up substantial reserves or the whole country will suffer. It should also be remembered that sometimes investors are entitled to dividends considerably above the normal level, for frequently they have taken long chances and there have been many failures; so, in considering what constitutes a fair return, there should be an averaging of earnings and losses. Consider the high mortality among early automobile companies.

In the case of railroads, there are other complications, too. In the past, railroads have often been guilty of discriminating between different sections and towns, favoring communities in which "insiders" have substantial real estate or other interests. Sometimes they discriminate in fixing rates for different commodities, as for example in handling different fuels, and there are cases where rates have been unnecessarily high on materials or parts needed for the manufacture of some article to choke competition with favored companies.

What is said of the railroad applies, in varying degrees, to nearly every "public utility." The recent and still unsatisfied demands for the expansion of telephone service require an enormous flow of capital, and it is unfortunate that oppressive taxation of business prevents the accumulation of earnings amply sufficient to meet this evergrowing demand.

A good picture of who owns the corporations is presented in a recent report of the United States Steel Corporation. There are close to three hundred thousand stockholders, an increase of nearly six thousand in a year. Of these, two hundred and sixty-eight thousand are individuals, nineteen hundred charitable and educational institutions, two hundred and forty-three insurance companies, owning over half a million shares, and twelve thousand trustees and estates.

The company has made a careful statistical study of their stockholders to determine just what kind of folks they are and the result of this study of two hundred and eighty thousand is very illuminating. From it we offer some interesting facts.

The notion that United States Steel's typical stock-holders are



people of great wealth is statistically exploded. Most of them are of modest means. Nearly three-fifths have incomes under \$5,000 a year. The incomes of 17% were between \$2,000 and \$3,000 a year. The median point was \$4,300, as many stockholders having incomes exceeding this figure as falling below it. Eight percent had incomes so small that they pay no federal income tax. Fifty-three percent have incomes lower than the wages paid to the steel-workers—\$4,500—and more than a third had incomes lower than the wages paid to steel-makers in the lowest wage bracket—about \$3,000. These wage figures do not include a recent pay raise of about \$200 nor a payment, averaging over \$400, made by the company for pensions, insurance and other "fringe benefits." Taxes equal about one quarter of the employment costs and are four times the dividend. Note that these figures of the incomes include *all* income, not simply the income from stock of the company but the total income of the stockholders. In a subsequent chapter we caution against too ready acceptance of statistical evidence: questions may arise of angles not here discussed, but we are satisfied of the soundness of methods pursued in this study and the justification of conclusions.

As this is written there is much discussion of tax reform and reduction, and there is frequent argument whether such programs should be framed to benefit "the poor working man" or "the rich stockholder." On the taxation of corporations more will be said later. Now we only touch on how the make-up of corporations bears on these questions. Does the picture presented of the "big steel" situation suggest that there is less contrast between the two groups than is generally supposed? Is it not possible that our adjectives should be transposed and is it not the "poor stockholder" who is to be commiserated, in many cases, rather than the "wealthy working man"? Would it not be wiser to frame our tax program on principles and on justice rather than on maudlin and misplaced sympathy?

### QUESTIONS

What is a corporation and what are its advantages?

Is the corporation capable of enjoying its profits, or is it capable of sinning or of enjoying life? Can it be punished? Or do these personal aspects apply to the stockholders as individuals and not to the corporation?

Do taxes paid by the corporation come out of the incomes of the stockholders?

Why is it double taxation to tax both incomes of corporations and dividend incomes of stockholders?

Do corporations make possible and more efficient businesses which are difficult or impossible for individual or partnership operation?

Should corporations be encouraged?

How may stockholders profit by inflation and bond-holders suffer?

Is it generally better that corporations be financed by stockholders rather than by loans?

What are the public service corporations and why do they call for regulations?