Michigan Law Review

Volume 26 | Issue 8

1928

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DURING the first years of the present century both promotional and manipulative swindling in connection with stocks and bonds flourished in the face of the obsolescent and poorly enforced fraud laws which were administered by prosecutors and courts inexperienced in corporate finance. It was not until 1911, after the securities problem had been put squarely before it by the state banking commissioner, that the Kansas legislature passed the first blue sky law to check the issuance and sale of unsound corporate obligations. Since 1911 the development of securities legislation has proceeded until at the present time forty-six states have statutes which directly regulate the issue and sale of corporate stocks, bonds and similar obligations.

The present state securities acts may be divided into two main types, fraud acts and regulatory laws. Fraud acts seek to prevent financial chicanery by following and punishing securities swindlers and thus frightening away other potential criminals. Regulatory acts, on the other hand, seek to prevent fraud before its perpetration by supervising, through a state securities commission, either sellers of securities or the securities themselves.

Regulatory acts primarily controlling sellers of securities are called "dealer-licensing" acts, under which brokers or dealers apply for annual licenses to sell for their own account securities issued by others. After being licensed, these professional dealers may sell freely during good behavior. So far as individual issuers of local securities are concerned, dealer-licensing acts require them to obtain specific permits in order to sell their single issues directly to the public.

As contrasted with dealer-licensing acts, other regulatory acts (and these are greatly in the majority) seek to control the securi-

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ties traffic by supervising each specific issue put upon the market. These latter acts are the "specific-approval" blue sky statutes, under which vendors of securities (whether issuers selling their own issues or professional dealers selling the issues of others) must submit to the securities commissions detailed information to prove the honesty and merit of their proposed flotations, and receive permission from the commissions to sell. The submission of such information for every issue to several states each operating under slightly different provisions requires much time and imposes a burden upon legitimate securities houses which sell stocks and bonds in many states, since the current interest rate may rise and cause a fall in the value of the securities in the hands of the dealers. Consequently the present specific-approval blue sky laws hasten the marketing process and so reduce this burden by two methods.

In the first place, the laws disclaim jurisdiction over certain securities (such as government bonds, public utilities issues and securities marketed by banks and trust companies), and also exempt certain transactions (such as sales to corporations, sales by or to building and loan associations, and isolated sales by one investor to another), in which securities or transactions fraud is considered to be unlikely. In the second place, a number of specific-approval securities acts provide for "registration by notification" or for "temporary approval," under which provisions legitimate issuers and dealers may obtain immediate permission to sell certain reputable (although non-exempt) securities by furnishing only a small amount of information concerning their flotations.

The operation and enforcement of these blue sky laws, especially the specific-approval statutes which are in effect in a majority of the states, may affect the securities field by raising standards of corporate financing and corporate administration in numerous ways and thus eliminating a portion of the risk involved in these companies' issues. For instance, limitations and restrictions placed upon "water" in corporate financing tend to raise the standards. The same end is forwarded by the limitation of organization and promotion expenses, and the careful consideration of the adequacy of the proposed capital. Again, it may be important to prevent the dissipation of capital by requiring that all funds be impounded until a sufficient amount has been accumulated to carry out the program of the corporation. As to the actual effect upon standards of corporation financing of the enforcement of blue sky laws, conclusions may be arrived at best by considering the practical requirements of the securities commissions along this line.

Escrow of Stock Issued for Intangibles.—When stock is issued by a company for some intangible asset such as patents, formulae or services, most commissions require that such stock be placed in escrow under conditions prohibiting its sale until the company shall have earned certain profits. The amount varies with the type of the enterprise. The escrow agreement often provides further that if the amount stipulated shall not be earned within a certain number of years from the date thereof, the stock shall be returned to the company for cancellation; usually this period is five years. The agreement also provides that in case of dissolution or liquidation during the period in which the stock is in escrow, the escrowed stock shall not participate in the distribution of assets until all other shareholders shall have been paid par for their shares in the case of par value stock. This sort of escrow agreement is designed, of course, to prevent promoters from making a profit out of a worthless patent, formula or some other intangible asset. If, within five years, the device can be shown practicable, the promoters may be entitled to the stock issued for such asset. It is significant that in very few cases have the terms of the escrow agreement been fulfilled and the stock thereunder been released.

Adequacy of Capital.—There is quite as much danger in the under-capitalization of a new corporation as in its over-capitalization, and some securities commissions frequently have occasion to direct the attention of promoters to the fact that they are not providing sufficient capital to enable them to carry out the program which they have outlined. The standards of corporate financing should be benefited by the avoidance of both over- and under-capitalization.

Limitation of Organization Expenses and Sales Commissions.—Virtually all securities commissions now restrict organization expenses of new corporations and the commissions connected with the sale of stocks and bonds by both new and old companies within some certain percentage of the par value of the obligations. This limit is usually 15 per cent., which would assure the receipt by the treasury of the corporation of 85 per cent of the face of the outstanding obligations. Obviously the limitations thus placed upon these promotional expenses and commissions comprise a conservation of capital. On the other hand, if securities sales necessitate greater expense, the officials feel that this is due to the lack of intrinsic merit of the issue, and that the project should not be inaugurated, especially just when its treasury is depleted by the sale of excessive commissions to stock salesmen.

Impounding of Funds Until Sale of Issue Is Completed.—In some states use is made of another provision to which the dissipation of capital has given rise, that is, the impounding of all funds received from the sale of securities until the distribution of the issue is completed. This temporary impounding of funds is the result of experience with many new corporations whose capital was largely dissipated before operations were begun upon any substantial scale. It may be helpful to stock salesmen to show pictures of beautiful factories, and to the inexperienced investor a handsome factory site and substantially built plants give an appearance of permanency and stability. But it is bad financing to sink all of one's capital in fixed assets; and especially is this true when an enterprise has neither demonstrated that it has a marketable commodity or that it has the ability to secure a market for its product. It is no burden to require the funds to be impounded until sufficient capital is obtained to assure an operating existence to the company. In fact, there have been frequent cases where it has been impossible to obtain enough funds, and the money on deposit with the trustee have been redistributed among the subscribers *pro rata.*

Attitude Toward "Management" Stock.—No uniform attitude has been taken by securities commissions toward the issue of non-par common stock exercising exclusive corporate control. The South Dakota securities officials take a radical position in this regard and refuse to authorize the sale of any non-par stock. Kansas and Illinois refuse to allow the sale of common stock under any circumstances unless it possesses voting power, while Pennsylvania has refused to approve the issuance, *without consideration,* of non-par common stock exercising exclusive voting control. On the other hand, Ohio, Wisconsin and most other major investment states have taken no definite stand against the issue of common stock which carries no voting power. In general it may be said that while there is some tendency toward restricting the issue of "management" shares, this tendency has not as yet developed much strength.

Attitude Toward Preferred Stock.—The tendency of securities commissions to protect the interests of preferred stockholders is indicated by a variety of practices. For instance, the Pennsylvania commission has insisted that all preferred stock issues must be preferred issues not merely by description, but must be preferred issues in fact, in that there must be a prior junior investment before a senior preference equity can be created. In most states, preferred stockholders must possess deferred voting power, to be exercised in case dividends on the preferred are unpaid for a certain number of years, or, occasionally, in case the company fails to maintain at all times net tangible assets equal to twice the outstanding preferred. In some states, the issue of non-cumulative-dividend preferred stock is not approved by the commission.

In Ohio, the commission will not grant a certificate to sell preferred stock unless the applicant promoters agree to pay an amount for the common stock at least equal to the expense of floating the preferred. For example, assume a company with 10,000 shares of preferred (par $100), and 10,000 shares of non-par common, to be sold to the public in units of two shares of preferred and one share of common at a sales expense of ten per cent, and the promoters to receive the remaining 5000 shares of common. In this case, the promoters would be compelled to raise $100,000 on the 5000 shares of common which they receive, in this way maintaining the preferred at par throughout the operation.

Again, the Wisconsin commission will not permit a new company or a company which has not been in successful operation to issue a straight preferred stock. In other words, in a business enterprise which has not established its ability to earn the preferred dividends, the commission requires either the participation in earnings for the preferred stock over its stipulated dividend, or the distribution of the common stock with the preferred stock so as to assure the preferred shareholders an equitable proportion of the profits.

Deferred voting power is given by the Indiana securities commission to realty preferred stock. This is the preferred stock of an Indiana corporation organized purely to hold real estate, and the stock issued by the company really takes the place of real estate mortgage bonds. The reason for this is that the preferred stock of Indiana corporations is exempt from taxation in the hands of third parties in Indiana. In this type of corporate financing, the commission has insisted that in the event of default in the obligations for one year, the preferred stockholders have equal rights with the common stockholders in the election of directors and officers.

Cases Illustrating the Effect of Blue Sky Enforcement upon Standards of Corporate Financing.—The following cases are indicative of the manner in which the administration of securities statutes conduces to an improvement in standards of corporate financing:

The Richmond (Wisconsin) Hotel Company was organized in 1925 with a capital of $75,000 of 5 per cent cumulative preferred stock and 750 shares of common stock without par value. The promoters proposed to take the common stock for an indefinite consideration. It was their intention to pay for it with such sum as would be necessary to equip and furnish the hotel, providing the proceeds of the sale of the preferred stock and a bond issue were not sufficient. The preferred stock was to be sold to residents of the community. It seemed to the securities commission that this was an unfair proposition. In the first place, there was no demand for a new hotel in that particular community except as it had been created by these professional promoters. The commission's experience with business failures had been that very seldom had their assets been enough to provide anything for preferred stockholders in case of bankruptcy, that is, that the preference as to assets meant very little. The commission refused to issue a permit on the basis of the proposed plan and advised the promoters that it would issue a permit only in case the preferred stockholders were given one-half the common.

The Bayfield Canning Company was organized in Wisconsin with a capital of $40,000 of common stock. In three years of operation it did not make a profit. The amount of common stock then outstanding was about $20,000. The company applied for permission to sell a straight 7 per cent preferred stock. It was to be sold to residents in the immediate vicinity of Bayfield. With the financial condition of the company, however, as serious as it appeared to be, the commission could see no justification for allowing a preferred stock issue to be sold. There was no indication that the company would operate more successfully in the future than it had in the past, and it had not been able to earn any profits at all, to say nothing of a preferred stock dividend. The commission advised the company that it would allow the sale of the preferred stock only in case the preferred were given participation in the earnings over and above its stipulated 7 per cent to the extent of five-eighths of such profits, or in case the articles were amended to provide for a non-par common stock so as to allow the sale of preferred and common stock in units of one and one at $101 per unit.

Another case in point is that of the Bay City Manufacturing Company, which in 1925 made application to the Wisconsin securities commission for the sale of $300,000 first mortgage bonds and $300,000 of 7 per cent cumulative preferred stock participating with the common *in dividends* up to an additional 5 per cent. The company had prospered for thirty-five years, but lost money since the world war due to the agricultural depression. No responsible investment dealer would underwrite the issues. The bond issue, it was hoped, would be taken largely by local investors who knew the past history of the enterprise. The commission pointed out that the declaration of dividends rested with the board of directors and it was doubtful whether the directors would ever give the preferred stockholders anything except the cumulative 7 per cent to which they were specifically entitled. The officials of the state suggested that the proposal be changed to provide for participation *in earnings,* but the officers of the concern objected to this as impracticable. They argued that such a provision would constitute an invitation to litigation as to what actually were earnings, and there might be endless friction as a result. Neither did they wish to sell the preferred stock with a bonus of common. The commission insisted, however, that since the preferred stock represented a speculative investment, the preferred stockholders were entitled to something more than a yield of 7 per cent, which, after all, was not largely in excess of what might be obtained upon a conservative bond. The final result was that the articles were amended to provide for an 8 per cent convertible preferred stock. The increase in the dividend rate served as an additional warning of the speculative character of the security. The right to convert the preferred stock into common, par for par, at any time before the calling of the preferred, or, at that time, on the basis of par for the common and $115 for the preferred, assured the preferred stockholder of his share of the future profits.

Supervision of Companies After Organization.—Another result of blue sky laws and their enforcement is a lessened mortality of new corporations in some states because the companies are introduced at birth to proper bookkeeping and a realization of the necessity of sound financial procedure in their business affairs, after which the securities commissions often continue their supervision for several years by requiring reports from the corporate officers. Executives of certain corporations, now well established, have confessed that their companies would have failed in their first year of existence had the officials not had constantly before them the necessity of rendering semi-annual statements to the securities commissions detailing the activities of their companies.

Comparing the present situation with that of the period prior to the enactment of effective blue sky laws, it appears to be the case that standards of corporation financing in most states have been materially improved by the administration of these statutes. Generally speaking, persons participating at present in the organization of new corporations and the financing of existing concerns are more particular in the arrangement of their articles of incorporation and are exercising greater wisdom in the fundamentals of financing the projects. Further, closer attention is being accorded, by the promoter, the corporate executive and the public alike, to the different privileges and obligations inherent in the issue of securities.