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During the recent cycle of inflation and deflation the capital problems of corporations have been emphasized in many ways. The asset write-ups and stock dividends of the '20's and the asset write-downs and reductions of stated capital of the '30's, as well as numerous other practices, were for the most part attempts to harmonize inflexible capital and changing asset values.

But this apparent search for flexibility has not gone forward without criticism. Abuses have been perceived which raise questions of doubt concerning the desirability of continued departures from the older methods of financing. For example, many corporations themselves are beginning to question the efficacy of no-par stock. And yet the objective of capital flexibility in itself still seems desirable.

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Note the background of the term "capital stock." That part of the owner's property which was active in his business affairs was at first very probably recorded (if at all) in a simple personal account—a credit to some sort of "master's account" by the slave or agent who was responsible for attending to business affairs. From the agent's point of view he "owed" the master for the sum entrusted; the master saw only a sum of money working in his behalf. To the latter this would be his "principal sum" and as the adjective came to be used elliptically as a substantive it would be thought of as his "principal." If the term had in this form been attached to his account, the title might be expected to have become "master's principal." When we see that the old Latin root word for the adjective "principal" was *caput* (head) and that this word evolved into the mediæval Latin *capitalis* and into the mediæval Italian *cavedale*, and finally into the English *capital*, it is not hard to convince ourselves that "master's capital" or "John Jones, capital" probably grew out of such a past.

Shift the scene to the seventeenth century. The trading companies, such as the East India Company and others, developed a species of enlarged partnerships. Each participant contributed from his stock of goods. The united contributions constituted a stock of goods which were owned jointly by the participants, in other words, a "joint-stock." Soon therefore "cash debitor to stock" was a typical opening entry. (For example, Dafforne, Merchants Mirriour, 1634, and Monteage *Debtor and Creditor Made Easie,* 1690.) "Stock" was here *representative* of the goods or economic capital held in joint-stock.

Presently the two terms crept together. For example, an act of parliament in 1697 regarding the Bank of England (8 & 9 W & M c. 20) mentions "the common, capital, and principal stock of the said Governor and Company ——." At present the combined terms "capital stock" are in constant use, but we seldom appreciate their inconsistency. "Stock" originally referred to the goods themselves and "capital" to the proprietor's principal sum (ownership in the goods). Yet combine these apparent opposites in a modern business corporation and we have still a third idea—a legal margin contributed by the shareholders for the protection of creditors. Today we often drop the noun "stock" and use the adjective "capital" to mean such diverse things as (1) the assets themselves, (2) the net worth of the proprietor, (3) the legal measure of the limit of dividends.

Obviously there are broad possibilities here for confusion of thought and action. But the more important matter for the present purpose is the thought that never in the long development of organized business and of accounting for business capital has there been any deviation from the principle that the capital account recorded the contribution made by the stockholders—never, that is, until quite recently.

Recent corporation practice in the United States, under the influence of factors, such as a greatly accelerated vogue for the corporate form for doing business, an increased appetite since world-war finance drives for security investments and the relative freedom from restraint which came in with no-par stock, etc., has evolved the doctrine of stated capital under which the directors or stockholders designate a portion of the contribution to be the creditor's margin and retain unrestrained control over the disposition of the remainder of the contribution as if it were accumulated profits.

This is a revolutionary departure from the conception which has persisted throughout a long evolution.

But a revolutionary practice should not be condemned on the ground that nothing new can be good. On the other hand mere novelty should not recommend a practice on the ground that everything old is inadequate for modern conditions. The use of a new idea in practical affairs should not alone constitute a sufficient endorsement, nor should the existence of abuses constitute sufficient reason for the abolition of a practice which has inherent merit. But anything which is as revolutionary as the doctrine of stated value does call for thoughtful appraisal.

Several alternatives suggest themselves at once. We could go back to the traditional conception of capital stock as the whole contribution and thus be free of stated value. We could also abandon entirely the idea of a fixed sum, however determined, as a margin for creditors. The first would be equivalent to a repudiation of recent developments and would require the restriction of many current practices. The second would be equivalent to accepting the revolution as progress and extending it to its logical sequel.

If we are to hold to the idea that capital stock represents the whole of the stockholder's contributions, it probably would not be necessary to abandon no-par stock entirely. No-par is much too useful to be legislated out of existence merely because it may be open to some abuse. No-par stock should be retained for the sake of its flexibility as an original issue, if for no other reason.

Restriction is needed, however, for stated capital in both original and subsequent issues. If the whole-contribution concept is to prevail, the stated-value concept must give way; the two are so antagonistic as to be irreconcilable. Therefore, any statute requiring the whole consideration for an issue of no-par stock to be credited to capital-stock account must also prohibit stated value. This will necessitate allowing complete latitude in the price at which the stock is to be issued.

The use of any statutory minimum price for stock issues would also constitute a failure to recognize the fact that there is no relationship whatever between the number of shares and the value of the property. In a sense a statutory minimum price constitutes an equivalent of par value as well as an invitation to establish a "stated capital" by resolution of the directors. If a minimum price for stock issues is included in the laws in an attempt to protect the investor against fraudulent stocks, this sort of protection could more properly be attempted through so called "blue-sky laws" which would classify shares as types of investments.

Another corollary to the fact that the number of owners can not affect the value of the property is that complete freedom should exist to increase or decrease the number of shares outstanding, by stock split-ups and recombinations, and openly to issue shares for intangibles and promoters' services. There would be little objectionable in these practices provided the public were given unmistakable notice of the facts.

In the case of subsequent issues of no-par stock under a statute requiring the whole consideration to be credited to capital-stock account, there might be a question whether this would not constitute an impairment of the rights of existing stockholders in the accumulated surplus. Since every share of common stock new or old is an undivided interest in the net worth, it might be argued that part of the purchase price was paid for an interest in the past surplus and therefore was not a proper credit to capital account. But since a credit to paid-in surplus or to earned surplus of a part of a capital contribution would be still more objectionable, the common-sense thing to do is to ignore the hair splitting and credit the whole consideration to capital. It may reasonably be presumed that the stockholders have voted on the question of the new issue and it will no doubt be agreed that the ability and the will to see in the proposal a dilution of existing equities can not be created by statute.

Perhaps these modifications and restrictions of no-par stock practice would not be sufficient to re-establish the principle of treating the whole contribution as capital. Recent developments away from a strict adherence to this earlier concept of capital stock may indicate a trend which is real progress. If this be true, then it would be a mistake to attempt to defeat progress in order to hold to the merely traditional.

Yet the issue may be deeper than the old and the new, the traditional versus the progressive. Under the earlier practice corporation finance was principally called upon in the formation of a new grouping of capital—the creation of a corporation where none existed before. Under more recent conditions corporate finance activities have been much more commonly directed toward merging existing corporations and re-arranging the capital structure of going concerns. The older problem was mainly one of assembling aggregates of limited liability capital under one management and issuing documentary evidences of the contributions. The newer problem is related to "values," to the growing consciousness that a corporation is being constantly "appraised" in the security markets, that its securities draw their value primarily from earning power, that assets are valuable only according to the earnings they produce. The modern problem of finance therefore is to try to maintain a reasonable degree of agreement between a naturally fluctuating element (value of assets) and a naturally rigid element (limited liability capital obligations). Hence the search for flexibility of capital which seems to be behind most of the capital problems of today.

These considerations suggest that a capital flexibility for corporations which would approach the flexibility of proprietor's capital might be desirable, provided the creditors of limited liability companies were given suitable protection, for creditor protection is still necessary if business on credit is to continue unabated.

The minimum margin of protection has heretofore been the capital-stock account representing either the whole contribution or a designated part of it. But in any event the capital has been a fixed sum. Obviously flexibility of capital and a fixed sum of capital are incompatible. So the question appears whether the creditors might not be given satisfactory protection without the use of a fixed sum of capital as a margin. If this were accomplished it should have the effect of making the capital structure more flexible so far as stock and surplus were concerned.

Assume the following legal restrictions upon corporate capital stock:

1. In lieu of a fixed sum as a margin for creditors, the corporation shall pledge itself not to allow the relationship between the total indebtedness (including preferred stock) and the reasonable value of the total assets to fall below a percentage which the corporation's charter agrees to maintain.

2. All preferred stock must have a par value expressing the liquidation preference in assets, is to be cumulative, callable, non-participating and preferred as to income (in order to exclude border-line cases which are closer to common stocks).

3. All common stock of whatever class must be without par value and may be issued for any consideration satisfactory to the directors and stockholders.

4. The creditors (including preferred stockholders) shall have the right to elect a certain number (minority) of directors annually.

5. Upon the failure of the corporation to maintain the specified ratio of assets and indebtedness, the creditors (including preferred

stockholders) shall immediately have the right to elect a majority of the directors.

6. Insolvency and the usual seizure through the courts of assets specifically pledged would follow upon the failure to pay interest or principal on a bond when due, as at present.

If the assumed restrictions were in force the following would be some of the expected consequences:

1. A plainer recognition of the principle that all suppliers of capital differ from one another only as to the terms of their "capital-contract" and that the corporation should be managed with the interests of all parties receiving consideration.

2. The creditors through their representatives on the board of directors would have a voice in the management and direct knowledge of current plans and policies. This representation, with the enforced maintenance of a definite ratio of assets and debt and the conditional right to control the policies, would be an effective substitute for a fixed sum margin and the so-called trust-fund doctrine of capital stock.

3. With the creditors thus better protected than at present common-stock account and surplus could be made as flexible as an individual proprietor's capital account. The legal necessity for distinguishing between common stock and surplus would disappear; a single "net-capital account" would suffice.

4. The "net-capital account" would be a true net worth account, a real indication of residual proprietorship, fluctuating as proprietorship fluctuated, subject to increase or decrease in the number of "participation certificates" as the holders saw fit and to such withdrawals or "assessments" as the directors, representing all suppliers of capital, should decide.

5. Although sub-accounts would be desirable for accounting purposes, a single account could suffice. It would be credited with:

Original contributions
Profits earned
Capital gains realized
Appreciation write-ups

It would be debited with:

Asset losses sustained
Asset write-downs
Dividends declared
Reserves transferred to special accounts

In the past, creditors' margin was the whole sum contributed by the stockholders; at present the tendency is toward a director-designated portion of the contribution, apparently in the search for greater flexibility of proprietary capital. The proposal here outlined increases the real protection of all classes of creditors and at the same time increases the flexibility of proprietary capital accounting and management. On the surface that would seem to be a desirable accomplishment.