

## DOMINION COMPANIES AND NO-PAR SHARES.

In view of the recent declaration of the Prime Minister of Canada, in which he included, among other promised reforms, the abolition of the privilege now enjoyed by Dominion Companies of issuing shares with no par value, it becomes a matter of interest to consider the nature of these shares and the extent, if any, to which they constitute an evil.

I find that even among business men there exist very hazy notions about the character of these shares. They are even sometimes surrounded by an air of mystery and high finance, and appear to carry with them a suggestion that in some magical manner they have advantages attached to them such as are not enjoyed by the plain, ordinary par value shares.

Many business men come to their attorneys and instruct them to incorporate companies with a capital stock made up of shares with no par value. Someone has told them that this represents the last word in business organization. In most cases they have not the slightest idea of just what is the purpose they are trying to accomplish by incorporating with these shares and whether they will be of any help to them.

In the first place, it is evident that this sort of security is not absolutely vital to the proper conduct of business. In England, which, after all, has a very considerable commerce, these shares have not as yet been adopted, and it would not appear that they have been missed.

We adopted them in Canada in 1917, after they had been used in the United States for about five years, and at first very few companies had stock of this description.

We still have a great many companies organized with par value shares, who do not find themselves handicapped in any way in their operation.

When I first investigated this subject a few years ago I was informed by a leading business man, who was then a director of the Bank of Montreal, that he did not know of any case in which these shares had been used for a good purpose. It is possible that this wholesale condemnation was going a good deal too far, but it represented the view of a business man whose opinions enjoyed considerable respect, and taken together with the Prime Minister's recent declaration it shows that there is a considerable feeling against this type of organization.

My own personal view is that these shares are in themselves quite innocent, that they are not so much a new scientific

improvement as a mere fashion, that there is not one of the advantages claimed for them which cannot be obtained otherwise with appropriate legislation, but that there are certain very undesirable features at present existing in our legislation which should be removed because they not only permit frauds upon investors to be perpetrated with ease, but actually give these frauds legal sanction.

The first advantage usually claimed for no par value shares is their accuracy. It is pointed out that there is no such thing as a one hundred dollar share or a share of any par value. The real value is always moving and depends on the changes in the company's financial situation while the market value fluctuates with every rumour and depends upon recognized laws of supply and demand. It is only accidentally and for brief periods that a stock ever sells on the market at its par value. It is suggested, therefore, that it is much more accurate to eliminate from share certificates any reference to a par value.

In the case of no par value shares, the shareholder is given a certificate for a certain number of shares, and the certificate shows also the number of shares which the company is authorized to issue, but it contains no reference to any value of the shares, and any such reference is, in fact, forbidden. The share certificate is, then, simply an indication of the proportion of the shareholder's interest in the company to its total authorized capital.

For the purposes of illustration—the shareholder having 10 shares of a par value of \$100 each in a company which has an authorized capital of \$100,000 gets a certificate establishing these facts. If, instead of having 1,000 shares of the par value of \$100 each, the Company had an authorized capital stock of 1,000 shares of no par value, the shareholder would get a certificate stating that he held 10 shares of no par value, and that the company was authorized to issue 1,000 of such shares.

I find it difficult to see the slightest difference in the two statements. One is just as intelligent as the other. In fact, neither statement is of very much use to the shareholder. What good can it do to him to know how many shares he has in proportion to the authorized capital. This will not help him to ascertain the value of the shares. For that purpose he will require to know what are the assets of the company and to know, not what is the authorized stock, but what is the stock actually issued and the terms on which new stock may be issued.

As almost every other advantage pointed out by the supporter of no par value shares is calculated to disguise the real operations

of the company, one may be pardoned a smile at the devotion to scientific accuracy which has been shown by writers on the subject.

Somewhat related to the first claim is the statement frequently made that an issue of no par value shares helps to prevent fraud. It is claimed that many people purchase shares of a par value of \$100 each, thinking that they are, in fact, worth that amount. If the shares bear no value it is claimed that the purchasers will at once make careful inquiries and will ascertain the real value of the shares.

I hope I am not unduly cynical in remaining extremely doubtful as to the desire of the stock salesman to stimulate careful enquiries as to the value of the shares he is selling.

I think that before accepting any such theory it would be well for any investigator to question a number of people and find out from them if, in fact, they consider that a share certificate bearing the figure \$100 is worth \$100. I have asked this question of a great many people, and on some occasions selected people whom I considered quite unintelligent, and I was surprised to find out that their ideas on this subject were not quite so simple as the theorist had assumed. A variety of answers would, no doubt, be obtained, and doubtless such opinions will be discovered, but I think it will be found that most people who are purchasing shares are not concerned with their par value, or particularly deceived by a par value statement.

On the other hand, I have come into contact with some cases where the no par value share had been definitely associated in the minds of the public with the par value shares to which they were formerly accustomed. In one case a company was purchasing land in order to erect a building and was taking options from the surrounding proprietors so as to make sure that it could buy all the land it required before going ahead with its venture. One of the holders of land with whom they negotiated was a business man of some experience, and they finally obtained an option from him and promised him 150 no par value shares in the proposed company. I found that this gentleman, who had a considerable business experience and who was generally regarded as a very astute person, had referred several times to this transaction as giving him \$15,000. He had not yet shaken off the old ideas, and it was quite plain that if he was a sample of many people of his class it would be quite simple for salesmen to dispose of no par value shares, which had been issued for a trifling consideration, to people

who would at the back of their minds associate them with a value of \$100.

As far as I have been able to see, the public mind with regard to no par value shares is in a state of confusion, and a fraudulent salesman is not interfered with quite so simply. He can carry on his activities equally successfully whether the shares have a par value or whether they have not.

Consider the ordinary investor going to his broker and being highly recommended to invest in a new issue which is being floated at \$10 a share. What does he do? Generally he relies on the opinion of his broker, especially where he is dealing with a financial house in whose undertakings he has some confidence. Personally, on any occasions on which I have bought shares I have simply contented myself with looking into the honest Scotch eyes of my broker and asking him whether the shares were worth that amount or not, and when he said they were I took his word for it. I never inquired whether the shares had a par value or not, and I believe that a great many shares are bought and sold in the same manner.

The two advantages above discussed with reference to the honesty and accuracy of no par value shares are those most frequently urged as being for the benefit of the public, and I think that as far as these claims are considered, we may safely come to the conclusion that the public does not improve its position in any way by a change from par value shares to no par value shares.

There are certain advantages which are in the nature of more or less innocent deception. If you issue shares of no par value for a trifling sum, let us say a dollar, and you have made unusually large profits and wish to declare a dividend of \$2.00 on each share, the declaration of your dividend will not arouse nearly the public attention that you would arouse on the street if your company declared a dividend of 200%. Take the case of a large public service company which now has no par value shares. It pays to its shareholders a dividend of \$1.50 per share, which is certainly a very modest dividend, but as the shares have been split so that each original shareholder now owns 18 shares, and as he has, in addition, had his original investment returned to him together with 50% added thereto, the real situation would be disclosed by stating that the company was paying dividends, at least to its original investors, of 27%, after having returned the original investment to them. Of course, one must not lose sight of the fact that a great many

of the present shareholders in such a concern have not acquired their shares on the same terms as the original investors.

The declaration of a large dividend now shocks modern ideas. It upsets the labour situation. It may attract competitors into the field, and it is sometimes claimed that no par value shares help to disguise the real extent of the dividend.

It will be noted that this is certainly not in the interests of greater accuracy, as so often claimed, but the idea here is to deceive the public, although, no doubt, the deception is innocent and possibly the real facts may be quite readily available to the public.

Accountants have sometimes told me that some companies consider it more satisfactory from a bookkeeping point of view to have shares without par value. The normal statement of a company with par value shares shows as a liability of the company the amount of its issued capital. It is claimed that a company with no par value shares does not need to show any issued capital as a liability, and that its statement is, on the surface, a much more attractive one. An appropriate footnote can be placed at the end of the balance sheet to indicate that the Company has so many shares of no par value.

This does not appeal to me as being of any real value and is clearly not in the interests of that accuracy so highly spoken of in connection with these shares.

If there is any advantage in attempting to deceive the public by such statements it can only be carried on with somewhat obliging accountants, and no doubt the custom among accountants in dealing with these shares will in time become as fixed as it was formerly with the par value shares.

A fifth advantage sometimes claimed is that the taxation upon companies with no par value shares is on a lower basis. It is, however, obvious that such an advantage is only local and temporary and depends entirely on the taxing statutes. If any taxing authority finds that someone is escaping a tax payment the hole is soon blocked, and such advantages tend to disappear very rapidly.

One such advantage occurs in incorporating companies with no par value shares in the Province of Quebec. For some reason or other, probably because of the confused ideas which existed even in legal circles about these shares when they first became known, the Province has chosen to assume that the value of the shares is \$5.00. If you apply for a Charter with 4,000 no par value shares you pay to the Province a fee

on a basis of \$5.00 per share, and your fee is \$40.00. If you incorporated a company with 4,000 shares of \$100 each you would pay to the Government a fee of \$235.00; yet immediately on getting your relatively cheap Charter for no par value shares you could issue these shares for \$100, or even more, and in this way you have saved a substantial amount in the Charter fee. Wherever the tax statute makes such an arbitrary assumption and places a fixed low value on no par value shares there will always be an advantage in using them until the Statute is amended, but this is not an advantage inherent in the shares themselves.

In the case of Dominion Companies the Department of the Secretary of State calls upon them for a statement as to the maximum value at which shares will be issued, and the Charter fee is based on that statement.

If a company does not want to commit itself to a maximum figure for its shares, the Secretary of State, for the purpose of fixing the Charter fee, deals with the shares as if they were worth \$100.00.

Another concrete illustration of advantages in the field of taxation is found in the Quebec Corporation Tax Act. That Act imposes a tax on companies carrying on business in this Province of one-tenth of one per cent of their paid-up capital, and sometimes this may be a very considerable amount.

Suppose, for instance, that the original founders of a company had sold to this company certain assets consisting largely of goodwill for \$1,000,000. par value capital stock, the actual physical assets sold to the company might really be worth only a very small amount. Let us suppose they are worth \$100,000.

In the case of the par value company its paid-up capital is the amount of stock it has issued as paid for. In this case it would be \$1,000,000. and the Corporation Tax would be \$1,000.

In the case of no par value companies the Corporation Tax Act taxes the real value of the company's capital. In a case such as the foregoing the company could make a real valuation of its capital of \$100,000. The tax would be \$100. The annual saving would be \$900. In other words, under the par value system a company which has heavily watered its stock will pay a correspondingly heavy tax to the Provincial Government, and this penalty for stock watering can be avoided under the no par value system. Of course, such an advantage will in each

case depend on the local statutes under which the company is taxed, and is by no means inherent in the shares themselves.

A sixth advantage which is often stressed is that no par value shares provide a more flexible medium for handling reorganizations, where companies have suffered reduction in their capital and wish to get new capital interested.

If the law forbids the issue of shares at a discount and compels a company to issue its shares for par, it is rendered more difficult to get new capital interested. No one will buy for par the shares of a company which is in bad condition, and the company may be prevented completely from financing by issuing common stock, and may be obliged to issue bonds, and thus assume a fixed indebtedness, or it may be forced to issue Preferred shares and give special terms to the new investors.

In the small companies the situation is sometimes met by a reduction of the capital. If a company has \$100,000 of capital stock and its assets have shrunk to such a point that they are only worth \$10,000, then the capital may be reduced to \$10,000, and each of the shareholders may be asked to turn back nine-tenths of his shares, and after this has been done and all the shares are substantially worth par, new capital may be sought for at the par value.

But the situation is not always so simple. What if the assets of a company are worth 36.3% of their nominal value, and the new capital wishes the old shareholders to scale down their holdings accordingly? One gets into complicated fractions and the procedure very easily becomes unworkable.

It is claimed that such situations are dealt with much more neatly and easily where the shares are of no par value. These shares can be issued under the present laws for any amount, and the provisions which forbid issue of shares at a discount have obviously no application to them. If the company issued the first no par value shares for \$100, nothing prevents it a year later from issuing further shares for \$50, \$10 or even \$1.00. If it becomes necessary to bring new capital into the company it is not necessary to go through any process of reduction, but simply to issue no par value shares at the market price.

This advantage has, to some extent, been exaggerated because, after all, in a good many such situations the procedure has been to organize a new company altogether and to make a fresh start. There is no doubt, however, that many cases exist in which such proceedings have been simplified by the existence of no par value shares.

There is, of course, another way of dealing with this problem, and it is the way which has been followed in England, under the Companies' Act of 1929.

The British Companies' Act now allows shares of a par value to be issued at a discount, under certain restrictions. The company must have been in operation for over a year, as obviously if discounts were allowed too near the commencement of affairs it would help companies to sell their shares at different prices and favour certain individuals.

Further, the necessity for issuing shares at a discount must be demonstrated to the satisfaction of the Court, and the approval of a special majority of the shareholders must be obtained.

With these safeguards there is really no reason why shares of a par value should not be issued at a discount, and if this amendment were made in our law, along the lines of the British Companies' Act, the advantage of flexibility for handling reorganizations in the case of no par value stock would disappear entirely.

Let us now turn to the more solid advantages which have been found useful in practice in dealing with stocks of this nature.

One manifest advantage, not to the public but to the company promoter, has already been referred to. It is that this type of organization overcomes the old rule that shares must not be issued at a discount. Under the old type of organization, if a promoter is selling assets to a company he is very often upon both sides of the bargain. He is interested in selling for the best price he can get, and, on the other hand, he or his employees are often in control of the company. In this manner a company promoter at the start of a company's life has often received substantial benefits, not always shared by the later shareholders.

The promoter who acquired the shares of a company under such circumstances was, in some cases, sued by the company or its Liquidator on the ground that the assets he had turned over for his shares were so insufficient as not to constitute a proper payment, and he was asked to pay the difference between the real value of what he has turned over to the company and the amount of the shares he had received. Such cases were unusual, but they did occur, and the fear of discovery that the shares were not legally paid-up had a moderating influence on the greed of the promoter under such circumstances.

With no par value shares a promoter may sell to the company without mention of any money consideration but simply for a



certain number of no par value shares, fully paid-up and non-assessable. Whether this can be done in any particular case depends, of course, upon the terms of the Statute under which the company is organized. In the case of a Quebec company, where a certain amount of capital in money is required before a company can commence business, it is obvious that shares can only be issued without reference to money value after the minimum capital has been subscribed and paid.

Where a promoter sells his assets in exchange for shares he has made no pretence whatsoever that the assets he was selling to the company were worth any particular sum, and he is entirely free from the fear that such a contract may be attacked later as a fraud upon the company.

An interesting illustration of this advantage to the promoter arose in an American case of *Piggly-Wiggly Delaware v. Bartlett*. In this case three promoters purchased a license to do business under this name for \$1,000. They incorporated a corporation called *Piggly-Wiggly Delaware*, to which they transferred the exclusive right to the use of the Piggly-Wiggly name in their jurisdiction, in exchange for 15,000 shares of no par value. No representations were made as to the value of the name or the value of the shares. The shares belonged to the promoters and the company's sole asset was the right to use the name.

The promoters then sold these shares which they had acquired as their own, and collected from the public about \$100,000. This amount, of course, went into their own pockets. The company still had to get funds with which to finance as it had nothing but a right to use the name. There were no other funds forthcoming unless the shareholders who had bought from the promoters were ready to carry on the company themselves and to invest more money in the venture.

The American Court in New Jersey stated that if the stock had possessed a nominal value the Court would have fixed a fair value for the license and would have condemned the promoters to make good the remainder of their subscription over and above this fair value. In this case, however, the contract for the sale of no par value shares could not be attacked, as there was no basis on which it could be stated that the promoters had over-valued these assets. On the contrary no value had been mentioned.

Even where a value is fixed for the assets sold to a company by a promoter there is still an advantage in connection with no par value shares. Suppose you are selling to a company assets

on which you place a value of \$10,000. With no par value shares you can arrange to have 100 shares, 1000 shares, or any number of shares which suits your purpose. If you are getting 5,000 shares in the above case the directors will fix the value, for the purposes of this issue, at \$2.00 per share.

One might ask under such circumstances if the same result would be achieved by providing for shares with a small par value, such as the Pound shares in England. This has not been popular on this side of the Atlantic. The promoter prefers a no par value share because if he uses a par value, even of a small denomination, subsequent purchasers will have the chance of paying at the same price as he has acquired. It is very difficult to get them to buy at over par, and usually the transaction with the promoter represents a sale of shares to him on much more favourable terms than is to be expected by the subsequent purchasers. If shares are issued without par value they are much more readily sold at a higher price than was paid by the promoter for his own shares.

This seventh advantage which we have outlined is, of course, an advantage to the promoter only. It is by no means an advantage to the public and, as in the illustration given, can even be disastrous to the interests of the shareholders.

The advantage to the promoter is, of course, only one aspect of the feature of no par value shares which has a much wider application. The old rigid rule that shares could not be sold at a discount has been done away with in so far as these shares are concerned, and the shares may now be sold at any convenient price. This is at times a distinct advantage to a company selling its shares and may be a good and honest reason in support of such securities. Instead of resorting to bond issues, which may place the company in the hands of the lenders, or issuing preferred stock, a company may market its common stock at a price attractive to the purchaser, and in this way a much more flexible method for raising capital is provided.

As I have already pointed out, this advantage is obtained in England without the use of no par value shares by permitting the sale of par value shares at a discount, subject to satisfactory legal supervision, and this may be a much better way of dealing with the situation than the system of permitting directors to issue shares at any price they may fix without restriction. The actual shareholders are at the mercy of the Board of Directors as to the price at which further shares may be issued. A company may be flooded with new shareholders at a low price just

as the House of Lords may be flooded with new peers. The fact that there is not one price for all if once thoroughly realized by the public would no doubt operate as a selling disadvantage against no par value shares.

During the days of the stock market boom a psychological advantage in favour of these shares developed of considerable importance in connection with splits of shares. Everyone knows that it is much harder to run up a high priced share than a low priced one and from a market point of view there is an advantage in splitting up a high priced stock so as to permit of sales in smaller units. If the split is analyzed it is clear that the shareholder has not received any particular benefit. If you are the owner of ten shares of \$100.00 in a company and the company exchanges these shares for forty shares of \$25.00 each, it is difficult to see in what way the shareholder is better off. Notwithstanding, announcements of exactly this nature, as in the case of C.P.R. stock, have been sufficient to send up the market price as much as twenty points.

The splitting up of a par value share involves exchange of certificates and after all does not bring much joy to the shareholder. In the case of the no par value share, the operation is in appearance much more attractive. If the shareholder holds 100 shares and the company desires to split these shares into four, as in the instance above cited, it issues to the shareholder a further certificate of 300 new shares of no par value. It may not be necessary for him even to return his former certificate. The average shareholder certainly feels that he has got something quite wonderful from his company although in fact the situation is exactly the same. He still is entitled to exactly the same proportion as he was formerly of the company's profits and capital when distributed.

Where shares have been split several times the no par value share has also been considered useful to avoid inconvenient fractions; thus in the case of the Montreal Light, Heat & Power if par value shares had been split into 18 the present par value of the shares would be \$5.55-59. It is obvious, of course, that in such a case the particular fraction in question would have been avoided and that there would have been no difficulty in a split into ten or twenty shares which would have meant a par value of \$10.00 or \$5.00. It would appear, however, that this feature had a great deal to do with the enthusiastic reception of no par value shares on the market, especially as stock brokers' commissions are on a substantially larger basis if high priced shares are split up into lower priced ones.

There are in connection with no par value shares certain very undesirable features which should be cured by legislation whatever happens to these shares. The first of these is the issue of such shares with preferred dividends. If a stock of no par value is issued with a preferred dividend of \$3.00 a share it is obvious that holders of common stock have an interest in seeing that the directors do not dispose of such shares at a low price. If such stocks were sold for \$1.00 a share; as the law permits, a preferred dividend of 300% would be created in such a case and it is, of course, grossly unfair to permit a large preference for a small contribution. A preference of \$3.00 per share does not look very large to people who are buying the common stock, but it may be sufficient to make the common stock entirely worthless.

For many years it was considered that preferred shares of no par value creating preferential rights to return of capital should not be allowed. In 1930 they were permitted by the Dominion Companies Act, but in 1934 this amendment was repealed and such shares are no longer allowed. The unfairness of such shares is even more obvious than in the case of dividends and they open the door to even grosser frauds. If such a share is created with a \$100.00 preference and is sold for a trifling consideration, then if the company goes into winding up the preferred shareholder may under such laws reap a harvest at the expense of the common shareholder. The Companies Act of 1934 therefore very properly forbade the use of such shares and it is submitted that the amendment might usefully have gone farther and abolished all preferred shares having no par value.

Another 1930 amendment which has provoked deserved criticism is that which has permitted companies selling no par value shares to segregate a part of the proceeds and call it distributable surplus. This surplus was declared available for dividends.

A very wholesome rule of company law has been that the company cannot impair its capital by declaring dividends. To permit a company to declare dividends out of the shareholders' subscriptions is really to legalize fraud.

Take one of the quite usual frauds perpetrated now for many years. A company advertises its ownership of oil wells in some remote state and incorporates a Dominion or Quebec subsidiary and sets out to sell shares in Canada, perhaps complying with all the laws on the subject. At first very few sub-

scriptions are received and the company pays dividends to the shareholders from the start on a generous basis. Your friend who has bought some of these shares talks to you enthusiastically about them but you have been bitten before and do not respond. However, when you hear that the company is actually paying a dividend you begin to wonder if you should not have taken a chance and when the dividend is repeated for a second, third and even a fourth quarter and the shares are now being offered at a higher price, you have a very high sales resistance indeed if you do not invest in the company's stock. These early dividends do not cost the company much where there are few shareholders and they serve as a most attractive bait. After a time the fish are bound to rush in and then one morning the office is closed, the directors have removed to parts unknown and are carrying on their activities elsewhere. Where the shares are of par value such directors are after all liable to arrest for fraud, and no responsible person would sanction the payment of dividends out of the company's capital because the directors are held personally responsible for the debts of the company if such dividends are paid, but with no par value shares this transaction can be operated with entire legality. You could ask your prospective shareholders to subscribe say \$10.00 of which \$9.00 will be distributable surplus and \$1.00 capital. Your stock salesmen are in a position to promise your shareholders that your committee will be on a dividend basis at once. This presents no difficulty as your dividend will be in proportion to the shares and if you only get a few subscriptions the dividend will be small.

A thoroughly undesirable feature of the distributable surplus is that the company is paying its shareholders dividends out of their own subscriptions. New companies may be launched on a much more attractive basis than if they could only pay dividends when they had become sufficiently established to earn profits. In most cases to promote such financing is to promote deception of the public. It is submitted that such companies really operate a savings bank without any protection whatever for the subscribers and that such companies are only able to obtain subscriptions on the strength of the fact that they propose to pay dividends at once.

The evil has been recognized to some extent because in 1934 the distributable surplus was cut down to 25%, but as in the case of the frauds above mentioned the promoter has disappeared long before 25% has been distributed, it is obvious that this amendment does not cure the mischief. The evil has usually

been done long before 25% of the company's capital has been used up.

It is submitted that in any new legislation the provision regarding distributable surplus should disappear. There is, perhaps, one case which might receive favourable consideration—that of a company which has taken over an already existing concern and purchased its assets, including its surplus and its reserves. The capital of the new company is represented by the assets it has purchased and it must be careful to see that it does not freeze the old surpluses and reserves by incorporating them into the capital of the new company and thus rendering them unavailable for distribution as dividends. No doubt this will not result where careful persons have been in charge of the incorporation, but it is a mistake which has sometimes been made and which may have embarrassing consequences. The present laws with reference to distributable surplus permit a company to create such a distributable surplus with retroactive effect provided it secures the consent of the Secretary of State and this provision has possibly some usefulness in curing some difficulties as above mentioned.

If these undesirable features were eliminated from no par value shares I think it may safely be concluded that the question of their retention or abolition is not one of primary importance. We have perhaps followed American practice too quickly and have forgotten that these shares were breaking new ground and departing from old well-established principles and, therefore, we should experiment with them with considerable caution.

On the whole I think it is clearly demonstrated that the public would lose little or nothing if these shares were abolished. If at the same time provisions were enacted such as those of the British Companies Act permitting the issue of shares at a discount, no honest business man would be hampered in his operations.

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Montreal.

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