<u>The Lost Debate on Stock Watering</u>

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One of the most significant political struggles of the late 19th and early 20th centuries concerned a subject which is not only foreign to modern ears but is easy to dismiss. Politicians, reformers, and regulators in this era all tried to end the practice of "stock-watering," or issuing stock for less than its "par value," usually $100 a share. Since 1912 in New York, however, it has been legal to issue stock without par value at all, and such new laws did not seem to have a major effect on financing. Most contemporary economists dismiss earlier concerns about "watered" or less than par-value stock. What, then, was the panic about stock watering about?

This article shows that the stock watering panic emerged first due to legitimate concerns about insider dealing and corporate monopoly. It also shows how stock watering, and monitoring stock issuance to prevent stock watering, became a central focus for the rising regulatory state, and how it permeated aspects of regulation often thought secondary to securities, such as railroad, utilities, and antitrust regulation, where issues of capitalization were paramount both for deciding reasonable rates of return and for protecting investors. Finally, it shows how these early railroad and utility regulations about stock watering became important though unacknowledged inspirations for securities regulation in general.

Despite public interest from contemporaries, the historical literature on stock-watering is thin. I have found only one eight-page article which directly addresses the issue.[1] A few articles discuss how stock

[1] Eric Hake, "The Stock Watering Debate: More Light, Less Heat," *Journal of Economic Issues* 35, no. 2 (2001): 423-430. The article focuses on accountancy in the period from the 1870s to 1917, and argues that the debate was about the "requirements of the modern industrial corporation," which required no par, and the "older proprietorship theory" of accounting for partnerships.

watering influenced other policies.[2] Even today, some historians continue to discuss concerns with "watered stock" without defining the term or what it meant.[3] This article tries to clarify how debates about stock-watering addressed issues of insider dealing, monopoly, and investor protection, and how it was an unacknowledged progenitor of much of modern regulation.

The Dangers of Watered Stock

The prominence of the stock-watering debate is easy to forget. Yet the 1892 Populist Party platform, the 1908 Republican platform, and the 1912 Democratic and Progressive Party platforms all demanded laws against the "overissue of stocks and bonds" or "stock watering."[4] In President Theodore Roosevelt's 1901 and 1907 State of the Union addresses, he railed against "overcapitalization" and "the evils of rebates and stock-watering." He demanded Congress "stop these practices by legislation."[5] President Taft promoted a bill that he said would "prevent stock-watering."[6] The seemingly esoteric issue was debated in popular magazines. [7] As late of the 1940 Presidential campaign, President Franklin Roosevelt railed against "watered stock" in utilities.[8] After the peak of public concern, politicians took credit for ending the practice. The 1952 Democratic Party platform claimed the party had "rescued American business from total collapse - from the fatal economic consequences of watered stock."[9] Even many of these pronouncements, however, were vague on what the term meant. The popular concerns with watered stock is even more surprising because, as one

[2] I.e., Marjorie Kornhauser, "Corporate Regulation and the Origins of the Corporate Income Tax," *Indiana Law Journal* 66, no. 1 (2000): 53- 136, which argues that a prominent reason for the corporate income tax was to supervise corporations and specifically to limit "stock watering." For treatment of the issue as part of a larger legal framework, see Herbert Hovenkamp*, The Opening of American Law: Neoclassical Liberal Thought*, 166- 170.
[3] See Richard White, *Railroaded* (New York: W.W. Norton, 2011). Much of the watered stock debate intersects with the discussion of liability of stockholders in banking companies, which was supposed to discourage risk-taking. David Turner, *Banking in Crisis* (2014).
[4] https://www.presidency.ucsb.edu/documents/1912-democratic-party-platform
https://www.presidency.ucsb.edu/documents/progressive-party-platform-1912
https://wwnorton.com/college/history/archive/reader/trial/directory/1890_1914/12_ch22_04.htm
[5] https://millercenter.org/the-presidency/presidential-speeches/december-3-1907-seventh-annual-message
[6] https://www.bookreporter.com/reviews/the-bully-pulpit-theodore-roosevelt-william-howard-taft-and-the-golden-age-of-journalism/excerpt
[7] "The Cheat of Overcapitalization," Will Payne, Everybody's Magazine, 1907
[8] Charles Hurd, "New Day, New Arms," *New York Times,* September 3, 1940.
[9] https://www.presidency.ucsb.edu/documents/1952-democratic-party-platform

prominent corporate law expert of the time said, the issue of stock watering "gives rise to some of the most complicated questions connected with the law of corporations."[10]

In its simplest manifestation, "stock watering" meant a corporation receiving less than a stock's full value in exchange for the issuance of securities. A corporation issued stock or bonds for a certain amount of money, usually "par" or $100 per certificate. If they didn't receive the full $100 for each stock or bonds, they were deluding future investors about how much had been invested in their corporation, and they were also diluting the value of previous stock and bondholders without warning them. Although the term contains some anachronisms when considered from the perspective of contemporary finance theory, mainly that the idea of stock value was retrospective and based on invested property rather than prospective and based on earnings, such "watered stock" could constitute real fraud on previous or future investors. Ultimately, it was a matter of false disclosure, or, as a modern corporate lawyer might say, a material misstatement.

Another reason fraud concerns were prominent was the "trust fund theory" of corporate capital. The idea was that the capital provided to a corporation should be a trust fund for debtors in a case of bankruptcy. Justice Joseph Story created the version of this theory in a 1824 U.S. Supreme Court case. As one New Jersey court case later claimed "subscriptions to capital stock constitute a trust fund for the payment of debts."[11] Thus any issues of stock for less than the stated par value defrauded potential bond buyers who would have less resources to rely on in a bankruptcy. The same went for dividends declared out of that initially subscriber capital, since it gave money to investors before the company had earned a "profit" by increasing its total capital. In this case, current bondholders would be defrauded to the early liquidation of assets.

The main dangers of stock-watering occurred when purchasers paid for stock and bonds in things other than cash. Whenever a purchaser paid cash for those bonds, the gain for the corporation was obvious. But the laws nearly always allowed the corporation to accept "property" or "labor" in exchange for stocks and bonds, and this opened up realms for fraud. A corporation could accept, say, a failing railroad on the impetus of one of its officers with an outside interest in that road, and pay for

[10] William Cook, *A Treatise on the Law of Corporations Have a Capital Stock*, 6th edition 1908, 118.
[11] 1906/01 The Issue of Corporate Stock for Propery Purchased – a New Phase, Yale Law Journal, Leonard Wallstein, 117.

it in stock worth three times the railroad's true value. In this type of fraud, the main issue was one of insider dealing. In England, such concerns led Parliament to require that whenever there was a payment for stock in something other than cash, the corporation had to provide public registration of the amount and type of property.[12]

A final concern was that stock-watering, also known as "overcapitalization," caused an increase in charges to customers. The theory was that since a railroad or utility required a certain rate of return on its stock and bonds, say, 6%, they would need to charge twice as much if their capitalization was $200 than if it was $100. Although this ignores that such corporations would always be trying to maximize their profit, it was a concern when states and the federal government began regulating rates of returns of certain corporations.

State Regulation of Watered Stock

The major debates around stock watering emerged after the Civil War. The first public discussion seemed to be around Western Union, and in 1866 congressional representatives said the main argument for public ownership of telegraphs was that Western Union was funded by "'watered stock,'" which both defrauded outside investors and increased the rates they charged for telegrams.[13] Most often, however, the debates happened at the state level. During the 1870 debates for the new Illinois Constitutional, the convention passed an act to provide 60 days notice before a corporation issued new stock. The goal was to prevent railroads from "declar[ing] dividends upon their watered stock." One advocate said it was for both "public protection" that might be caused by excessive charges and "the protection of stockholders." Immediately after this debate, the convention discussed creating the "board of railroad and warehouse commissioners" to see that the "laws and regulations of the State are enforced." It was clear that one of these laws they wanted enforced by the commission was the limitation of stock watering.[14]

Courts from early on refused to permit corporations to issue stocks and bonds below par, since these acts were considered *ultra vires* or beyond the competence of the corporation. But in the second half

[12] Cook, *Treatise on the Law of Corporations,* 114-116
[13] Lester Lindley, Watered Stock and Control of Telegraph Rates: Early Proposals for Regulating a Public Utility, *Journal of Economic History* 1972
[14] Illinois Constitutional Convention, 1869-1870, Volume II, 1647-8.

of the 19th century, courts came to allow corporations to perform almost any activity that was not strictly prohibited. Legislatures in America then began to fashion a number of other remedies for stock issued for less than par, especially when they were issued for undervalued property. Generally, state laws allowed only "recession" or the return of stock for the overvalued property. Who and when such a recession could be enforced was an issue. A corporation itself had a remedy against directors who issued stock in fraudulent manner, and creditors could object to transactions that provided stock to others for less than par.[15] But the main remedy was during bankruptcy, when the overpriced stock was revealed to creditors. In that case creditors could sue the holders of stock who paid less than par to get the remainder, but the courts had generally agreed that such sales had to be fraudulent, and not just a mistaken valuation.[16]

U.S. states tried to pass increasingly strict laws against companies accepting overvalued property for stock and bonds. From the late 1860s, at least 17 states put laws against stock watering in their state constitutions. The general clause was similar in most cases, and usually read: "No corporation shall issue stocks or bonds except for money, labor done or money or property actually received and all fictitious increase of stock or indebtedness shall be void." Such clauses increased the ability of innocent stockholders or creditors to sue to reverse the "fictitious" transactions, but again, courts often limited their impact by narrowly defining fictious, and refusing to void transactions that were not clearly fraudulent.[17]

State regulatory commissions, which arose in the second half of the nineteenth, were seen as another means to limit stock-watering and specifically to protect investors against watered stock. One of the earliest powers of commission regulation in the United States was the auditing and publication of regulated corporations' accounts. Although typically seen as a mere side effect of commission rate regulation, at the time many argued that such publicity was an important step for investor protection. In fact, arguably the first permanent regulatory commissions in the US, the state bank commissions in the 1820s and 1830s, were created with a similar impetus to expose the public accounts of inscrutable corporations, and this was seen as a protection to depositors and stockholders in banks.[18]

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[15] Cook, *A Treatise on the Law of Corporations,* 122-128.

[16] Some states like Minnesota had ruled that less than par sale was legal, but allowed creditors who relied on a false representation of total capital stock to sue. Ibid, 158-160

[17] Ibid, 194.

[18] See Glock, The Forgotten Visitorial Power," *Review of Banking & Financial Law,* 2014.

Although many note that the Massachusetts's Board of Railroad Commissioners, the first established such commission in the U.S. in 1869, was a mere "advisory" commission, with no independent rate-making authority, the following year the state established the Massachusetts commissioner of corporations, which did have substantial authority. This commissioner had to approve each new incorporation and required that all capital, including for railroads, be paid in cash or in independently valued property. The railroad commission soon adopted this authority and also gained authority to define the timing and terms of certain railroad securities sales.[19] In 1887 the railroad commission was required to approve all additions to capital of street railway corporations before their issuance, an incredible power for supposed advisory commission.[20] As one commentator said, capital stock could only be increased by consent of the commissioners, and therefore "every increase of stock is equally well protected against watering."[21] Or, as another researchers, the Massachusetts Commission, "while having only advisory powers in matters of rate making since 1869, was given full authority in the sphere of regulation of the issue of securities."[22]

But Massachusetts took a bigger step in 1894 with its "Anti-Stock Watering Act." This gave the railroad commissioners, and related boards such as the Gas Commissioners, power to supervise and approve all issues of stock and bonds by gas, telegraph, electric, railways of all sorts and other public utilities. The commission, as one economist said, would had to "examine assets and liabilities, secure expert valuation, and investigate purposes for the issue of stock or bonds."[23] One 1901 article on the Gas Commission claimed that "it is inevitable that the chief formal or public work of the Commission henceforth will be the trying of petitions for increase of capital."[24] As William Cook, the premier corporate attorney of the era, who was suspicious of most attempts to ban stock watering, said, "There is but one state in the Union which has succeeded in eliminating most of the evils of stock-watering.

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[19] 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, *American Economic Review*, 553. From 1869 to 1872, the Commission prohibited issues of stock except at par. From 1872 to 1878, it demanded that it all be sold at public auction.

[20] 1890 MA Board of Railroad Commissioners Report, p. 45.

[21] 1890/09 "State Control of Corporations and Industry in Massachusetts," George K. Holmes, *Political Science Quarterly*, 422

[22] 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, AER, 553. Concerns about over strictness led Massachusetts in 1908 to switch to approval of price by stockholders, followed by confirmation by commission, and in 1909, approval of working capital issues allowed by legislation.

[23] 1900/03 The Principles of Governmental Regulation of Railways, by Emory Johnson *Political Science Quarterly*, 38.

[24] Some earlier corporate charters had required approval of board for certain issues, 1901/02 John H. Gray "Competition and Capitalization in MA Gas Commission," *Quarterly Journal of Economics*

That state is the commonwealth of Massachusetts."[25] In 1904 the commission's power was extended to all public service corporations.[26]

One way of preventing watered stock and ensuring regulated rates was a "valuation" or a public accounting of all the value of the property of the regulated corporation. As regulatory economist William Z. Ripley wrote, "Texas was the pioneer in this field." In 1893, Texas passed the "Stock and Bond Law" requiring an accounting of all existing property and which required all new stock to be based on real assets. As Ripley said it was "not primarily with a view to rate regulation but to prevent stock-watering," and its purpose was thus similar to Massachusett's anti-stock watering act of the following year. Ripley said in the next decade the Texas law caused a reduction in "capitalization" from $41,000 to $32,000 per mile of railroad.[27]

Other state railroad commissions, including many considered "advisory," soon received the power to approve any increase in railroad stock, such as Indiana, Illinois, Louisiana, Maine, Maryland, Mississippi, Missouri, New Hampshire, New Jersey, South Dakota, and Wyoming. By 1906, only one-half of states did *not* have laws limiting the issue of railroad stock, and this was all before the beginnings of "blue sky" legislation regulating stock issues in general.[28] While some state courts, such as Minnesota, struck down such commission laws which required the approval of corporate financing, most upheld them.[29]

The movement to regulate stock offerings was one of the most important victories of the early public utility regulators as well. Many have noted the passage of the Public Utility Commission laws in Wisconsin under Governor La Follette, and New York under Governor Charles Evans Hughes, both in 1907. These are typically portrayed as attempts to centralize and streamline control of railroads, telegraphs, and other utilities in one place. But the most important addition to these commissions' powers over those they supplanted was that they received the authority to approve stocks and bond issues by utilities, rather than just railroads. In Wisconsin, the legislature in 1907

[25] Cook, *Treatise on Law of Corporations,* 200-201.
[26] 1908/08 Massachusetts Anti-Stock-Watering Law *Quarterly Journal of Economics*, Grosvenor Calkins, 640
[27] 1907/12 William Z Ripley, "Railroad Valuation" *Political Science Quarterly*, 580-1.
[28] Balthasar Henry Meyer, *General Railway Legislation,* 162-3; See list in National Civic Federation, *Commission Regulation of Public Utilities* (New York: National Civic Federation, 1913), 850-871.
[29] State v. Great Northern Railway 111 Nw Rep 289 1907

forbid the issue of less than par value for stock or bonds up to 75% of value. It allowed the Commission to investigate and certify that all stock and bond issues were actually at full value before issuance and payment.[30] In 1911 Wisconsin expanded the commission's authority over stock issues. As Charles McCarthy, one of the intellectual progenitors of the law, said, for ratepayers it would have little importance, but for "stock and bond" holders it was crucial.[31]

New York in fact had been trying to use its railroad commission to regulate stock offerings for years. After New York State reformed its railroad commission in 1882, then Governor Grover Cleveland said that one of the most important attributes of the commission was "requiring the filing of quarterly reports by the railroad companies, exhibiting their financial condition." He said that since the "state creates these corporations" and they are "launched upon the public with the seal of the State in some sense on them," they had a duty to ensure the integrity of the stock. The commissions would ensure that "[t]he funds of its citizens should be protected by the State which has invited their investment." For that reason, he said, the filing of quarterly reports should be extended to other corporations chartered by the state. These regulations would "not be favorable to stock speculation, but they would protect the innocent investor." Later Governor David Hill proposed the same authority in four other annual addresses, along with suggestions about expanding the railroad commission's regulatory authority to also deal with gas, telegraph, and other utilities.[32]

The 1907 public utilities act addressed these issues. One New York state official said that before the passage of the act there "was great dissatisfaction and great cause for dissatisfaction" most "especially in the matter of the issue of stocks and bonds." He said the abuse of stock and bond issues was "the immediate motive for the enactment of the Public Service Commissions Law. It was not so much the question of the regulation of service and the fixing of reasonable rates in its origin, as it was the protection of the investing public."[33] Governor Charles Evans Hughes advertised the new law requiring approval for stock and bonds in his next campaign. His campaign also claimed the

[30] 1907 Green Bag 19 "The Wisconsin Public Utility Act" Eugene Gilmore. In 1911 the act was amended to allow Commission to determine whether purposes were lawful and amount necessary for issuance, 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, *American Economic Review*, 560.
[31] Charles McCarthy*, The Wisconsin Idea*, 1912,
[32] Statement copied in 1915 New York Constitutional Convention, vol. 2, 2144-7.
[33] 1915 NY Constitutional Convention, Volume 2, 2143. One editorial suggested allowing the commission to approve the issue of all new stocks of any corporation. 1908/01 *Bench and Bar,* Edited by Archibald Robinson Watson, 12, no. 1 "Stock Gambling," p. 1

Democrats were hypocrites when they attacked "Government by Commission" since they asked would people rather have "unlimited water" without a commission or "fair capitalization" with a commission?[34] Both Wisconsin and New York, as with most railroad commissions, required regulated utilities to report public accounts of all finances as a protection to investors.[35] As one New York state report said, "While the commission does not, in making authorization of securities in any way guarantee that the securities so authorized are a good investment, yet it is earnestly endeavoring to bring it about that the financial statements on the basis of which such securities are sold may be such that the investor will not be misled."[36]

States and their commissions pursed a variety of other tools to reduce stock watering. In Ohio railroads had to report to the railroad commission the cost of all stock and bonds, as well as the cost of building their roads, and the former could not exceed the latter at any point. In Pennsylvania and Indiana the stock was limited to a certain dollar amount per mile of railroad. States like Arkansas and Kentucky required majority votes of stockholders for increases in capitalizations. In New York the commission required public sales of securities, instead of negotiated or private sales, to maximize prices.[37] Utah required any property given in exchange for stock to be evaluated by three independent individuals who signed to its value. Massachusetts was held as the paragon of preventing stock-watering. Its railroad commission prevented companies from capitalizing floating (or short-term) debt into long-term stocks and bonds and prevented capitalizing depreciation when calculating dividends, which it said "is to capitalize a loss." The board even proposed the price of shares and bonds to be issued.[38]

Even if other states did not give their utility regulatory bodies approval authority over stock and bond issuance, they gave other, more often forgotten, bodies the same authority. Along with Virginia's new constitution and the creation of the State Corporation Commission in 1901, the state required every corporation to submit a statement with the commission before issuing stock or

[34] Public Service Commissions, typewritten [prepared for Campaign book]," box 149, CEH Papers, LoC Manuscript Division.
[35] Note Historical Economy article on state gas commissions as attempt to protect investors, but mainly by avoiding
[36] 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, *American Economic Review*, 551.
[37] 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, *American Economic Review*, 550.
[38] 1916 [report published 1915/03/15] Joseph Davies, Commissioner of Corporations, Trust Laws and Unfair Competition, 219.

bonds, setting forth financial plans for issues, and verifying them by oath.[39] In 1907, the same year as the New York and Wisconsin commissions law, Iowa passed an act that every corporation had to apply to a state executive council to issue stock, which had to be accompanied by sworn statements as to value received and which the executive council could refuse.[40] Then twice, and soon to be three, time Democratic presidential nominee William Jennings Bryan addressed the Oklahoma constitutional convention in 1906, appropriately, right after the address of the head of the Texas railroad commissioner, to say that the state should create a "Board of Corporations" to prevent "watering of stock," which should have power to audit all utilities and endorse any stock issued. The commission was part of the 1907 Oklahoma constitution.[41] By 1915 22 states required some form of submission and approval before any corporation could accept property for stock.[42]

"Blue Sky" legislation against stock speculation, beginning with Kansas in 1911, and adopted by 47 states by 1931, in fact mimicked many of these earlier regulatory authorities and had a particular focus on watered stock. These laws in fact allowed existing banking commissions, which, as noted above, were created to support investors in banks, to approve or disapprove new securities issues based on broad criteria. Some of these explicitly forbade issuance of securities by any company that had previously issued securities in exchange for patents, goodwill, or intangible assets, unless the commission agreed that such securities were done for par value.[43] Previous literature has not acknowledged how these laws were rooted in the same laws about stock approval and watered stock that regulatory commissions adopted years or decades earlier.

The issue of watered stock was also a constitutional concern in regulating corporations charges. States courts had long held that legislators and commissions could not make rates for railroads and utilities so low as to be an effective "taking" of property. But the correct rates for those corporations had to be based on how much funds investors had provided. If the capital base of a corporation was too large because of stock-watering, regulators could constitutionally reduce rates below the typical

[39] 1916 [report published 1915/03/15] Joseph Davies, Commissioner of Corporations, Trust Laws and Unfair Competition, 219.
[40] 1907/11 Frank McDermott "Stock Watering" *American Political Science Review*, 69.
[41] 1906 Oklahoma Convention, 395. There were other variations as well. Utah requires the property to be evaluated by three independent individuals who signed to its value.
[42] 1916 [report published 1915/03/15] Joseph Davies, Commissioner of Corporations, Trust Laws and Unfair Competition, 219.
[43] Mahoney, "Origins of Blue Sky Legislation," *Journal of Law and Economics*; Macey and Miller, "The Origin of Blue Sky Laws," *Texas Law Review,* 1991

"reasonable" return. As Justice John Marshall Harlan said for the U.S. Supreme Court in *Smyth v. Ames* in 1898*,* which for the first time defined rate regulation as a potential taking of property under the 14th Amendment, "If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is largely fictitious, it may not impose upon the public the burden of such increased rates."[44] This ruling, and many subsequent ones delineating what was a "reasonable rate," provided another impetus for controlling the valuation and capitalization of utilities through the control of watered stock.

There was one notable contradiction in many of these attempts to limit capitalization. Many states wanted to tax companies based on the highest possible valuations, even while they wanted to regulate rates based on the lowest. Thus while many utilities commissions advocated for "replacement cost" as the correct base of capitalization, only using the current value of real property, many tax commissions, which also arose as a forgotten administrative body in this era, adopted the "earnings power" test or the market value of stocks and bonds as the starting point of taxes, especially franchise taxes on utilities. In the latter case, they were admittedly accepting the rate emerging out of "watered stock." The states thus adopted two distinct tests for estimating the value of precisely the same thing, depending on where they perceived their interests to lie, and in each case the extent of stock watering was important to the debate on the charges.[45]

Federal Stock Watering Legislation

Stock-watering concerns were prominent in the earliest debates on federal regulation, including in the debates on the creation of the Interstate Commerce Commission. The famous Windom Report on railroad regulation, issued by the U.S. Congress in 1874, had the usual recommendations for publication of freight charges, prohibition of consolidations, forbidding long versus short-haul discrimination, and so forth. But it's fifth recommendation was against "stock-inflations, generally

[44] Smyth v. Ames, 1898.

[45] 1901/02 ERA Seligman, comments on "The Taxation of Quasi-Public Corporations: Discussion," Pubs of AEA; 1907/12 William Z Ripley, "Railroad Valuation" *Political Science Quarterly*. Some boards would deduct the physical value of the property, assuming that the value of the stock over and above the property indicated the "excess" value of the company or franchise. In some of those states that later allowed no-par stocks, they just taxed stocks as if they were still at $100 par, and Congress did the same thing in World War I tax act. 1921/04 Michigan law Review "'Watered Stock' – Commissions – 'Blue Sky Laws' – Stock Without Par Value, Vol XIX, No. 6 William Cook, *Treatise on Corporations,* 591.

known as 'stock-waterings,"' which it called "wholly indefensible." It noted the "remedy for this evil seems to fall peculiarly with the province of the States who have created the corporations," but it said the "evil is believed to be of such magnitude as to require prompt and efficient State action," along with any possible national action.[46] Of the "principal causes" of extortionate charges, the first mentioned was '"stock-watering."' The report then again emphasized, after seven other complaints, that "of the defects and abuses above enumerated, perhaps none has contributed so much to the general discontent and indignation as the increase of railway capital by '*stock-watering.'*" It finally thought that railroads, due to their "stock-inflation," were "rendered incapable of performing the service required at reasonable rate." One important remedy for such stock waterings was requiring full accounting reports on railroads' financial conditions, which would protect both the public and investors.[47]

Similarly, the 1886 Cullom Committee report, which led directly to the ICC bill, noted that recent reform agitation had been for "the protection of the interests of stockholders almost as urgently as for years past it has been sought for the protection of the people who use" railroads. It also said that "stock watering…has unquestionably done more to keep alive a popular feeling of hostility against the railroads of the Untied States than any other cause." Although it again said the states had to take primary action against watering, the federal government could get at the "desired result by causing the financial operations of all interstate roads to be thoroughly investigated and by requiring of them such detailed reports as will accurately exhibit their action condition." Uniformity of bookkeeping and accounts and the "publicity" of investigations would help "preventing illegitimate transactions in the future." The report finished its section on stock-watering with the statement "the committee further believe[s] that such investigations should be conducted under the direction of a national railroad commission, and that the importance of this work furnishes and strong argument in favor of the creation of such a commission." This is the first time the commission is mentioned in the report, and it is followed by an extended argument on a commission's necessity, which thus followed from the need to prevent financial fraud.[48] As one farmer said to the Cullom committee, "there comes the necessity for the regulation by the Government, and the establishment of a uniform system of

[46] U.S. Senate, Report of the Select Committee on Transportation-Routes to the Seaboard, Report 307, Part 1, 43rd Congress, 1st Sess. 1874, 241.
[47] Ibid, 71, 74.
[48] Cullom Committee Report, 47, 51-2.

accounts, with a regulation by the Government as to how they should kept, so that the public itself may know when the stocks of a corporation are watered and when they are not."[49]

Federal concerns with stock-watering cresconded in the first decade of the twentieth century. President Theodore Roosevelt was obsessed with the issue. In a 1905 speech Roosevelt said he wanted "increased regulatory and supervisory power" exercised by the Government over railways, and provided for an example, "for instance, I would greatly like to have it exercised in the matter of overcapitalization" since "I am convinced that the 'wages fund' would be larger if there was no fictitious capital upon which dividends had to be paid." When President Roosevelt elaborated on his plans to prevent watered stock in early 1907, he had to assure investors he did not one to go too far. A page one story in the *New York Times* declared "Old Stock Safe, Says Roosevelt," who argued that he had "no intention of squeezing any water out of present railroad securities" and that his proposal would just restrain future issues.[50]

In 1910 the U.S. House of Representatives passed a bill that required railroad stock issues to be regulated by the federal government, but the Senate refused to oblige and instead substituting a provision creating a Railroad Securities Commission to investigate. Before the report was even issued, then President Taft, in line with the 1908 Republican Platform, recommended that the ICC be given power to approve stock issues and to ascertain any property in exchange for stock to make sure it was not less than par value.[51] At the time, most investors did want some regulation and publication of information on stocks. John Moody, of *Moody's Bond Buyer*, argued that "Federal control of securities would be desirable" due to "stock jobbing and other evils incident to the watering of stock," which "would be remedied by Federal control."[52] Jacob Schiff, a Wall Street insider who worked with several railroads, also said that the federal government should prevent issuing of stock under par and provide information on potential stock-watering.[53]

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[49] Hearings, 1885, Select Committee on Interstate Commerce, 1171, Jabez Burrows statement.
[50] "Old Stock Safe, Says Roosevelt: White House Statement Says he Would Stop Only Future Stock Watering," *New York Times,* April 2, 1907. Noted White House dispatch that President will again deal with overcapitalization of railroads. He asked last session of Congress, but nothing done. [Also notes that in regards to investigation of rebates and other issues, he wants commission power to inquire as matter of right not mastter of favor. Not revolutionary because "I only wish the same power given in reference to railroads that is now exercised as amatter of course by the National Bank Examiners"
[51] January 7, 1911 special statement to Congress, quoted in 51 Cong. 9791, June 4, 1914.
[52] "Wants Federal Control," New York Times, January 27, 1911
[53] "Schiff Wants One Control," *New York Times,* December 20, 1910.

The final report of the Railroad Securities Commission recommended "stringent provisions regarding publicity of stock and bond issues" and a physical valuation of all interstate railroads. But they refused to endorse giving the ICC pre-approval of stock issuance.[54] *The Commercial and Financial Chronicle* praised the report, saying it has "never been surpassed by any public document that has come under our notice," and said that they had been advocating publicity in railroad stocks for 40 years. Their only complaint was that it was too "tentative" in its recommendations and thought it should go further.[55] In 1913 Congress passed the Valuation Act, which required a physical valuation of all railroads to make a more secure basis for both rate-regulation and stock issuance.

No Par Stock and Continued Regulation

The Railroad Securities Commission did offer an intriguing and counterintuitive recommendation for limiting the problem of watered stock. It suggested that stock could be issued without par value at all. The main issue they identified was that a corporation whose stock price was less than par in the market could no longer raise funds by issuing new stock, and thus either had to take on debt or simply not raise any more capital. Although some state courts had created an explicit exception for issuance by companies whose stock prices in the market were under par, in other states it was perilous.[56] At the same time, some were concerned that the par value requirement, since it could not effectively be enforced through most litigation, outside of the regulated sectors, in fact encouraged fraud against the investing public by making them believe the value was sometimes higher than the stock market price.[57]

For years, arising simultaneously with concerns about watered stock, there was an increasing concern among lawyers that courts enforcing watered stock, often in the midst of a banrkutpcy, could not decide the true value of stock sales sometimes issued in exchange for property decades earlier, and

[54] Report of the Railroad Securities Commission (Washington: GPO, 1911)
[55] "The Report of the Railroad Securities Commission," Commercial and Financial Chronicle, December 16, 1911.
[56] Cook, *Treatise on Law of Corporations,* 155-157. The US Supreme Court upheld this line of cases in 1891 in Handley v. Stutz, and, as one lawyer admitted "A clearer case of judicia law making in the interest of 'expediency' would be difficult to find."' 1924/05 James C. Bonbright "The Dangers of Shares without Par Value," Columbia Law Review, 453. Although the general tendency was for all stocks to issue at $100, some railroads could issue stock for $50, and mining company stock sometimes had $5 or $1, or even 1 cent, par since they were more speculative. And a few associations, not officially incorporated, had no par values. 1910/05 John Adams Jr. Stocks and Their Features, AAAPS, 525.
[57] 1924/02 The Progress of the Law on No Par Value Stock, Cornelius Wickersham, *Harvard Law Review*, 464.

thus courts could subject both directors and stockholders to ruinous lawsuits based on voiding transactions that may have occurred years or decades earlier. In general, as William Cook said in an oddly poetic moment, the "flood of litigation" with little concrete result, ends up leaving "the investor on an unknown sea, without chart, compass, landmark or pilot."[58]

To this end, in New Jersey's Act Concerning Corporations of 1896 said the "judgment of directors as to value [of property] shall be conclusive." As long as the directors acted in "good faith" there would be no liability or voiding of stock issuance. One lawyer wondered if New Jersey, in avoiding the problems with earlier laws, hadn't "rushed to the other extreme." But similar laws arose at the same time in most of the corporation-friendly states, such as Connecticut, Delaware, Maine, and New York.[59] The New Jersey law also allowed the issue of stock at any par value whatsoever, either $100 or $1.[60] These laws obviously did not quiet the concerns of those who worried about over-watered stock, but it did lead some to advocate the end of par value entirely, since they believed par value more easily encouraged rather than discouraged fraud by making many assume the stock or bond was worth a particular value, rather than the value in the market.

The year after the Railroad Securities Commission report and recommendation, 1912, New York state passed a law allowing the issue of no-par stock. By 1924 34 states had laws allowing no par stock.[61] Some holdouts continued to rail against the change, claiming that it ended any possibility of suing shareholders for not paying for value and for directors for issuing dividends out of capital.[62] But, contrary to some modern researchers, these laws did not end the debate on stock-watering and many advocates against the practice of stock-watering embraced them. Victor Morawetz, the prominent progressive corporate lawyer, wrote that "the policy of the New York Statute is sound," but still railed against stock watering and said there were still a need for federal laws to keep the base of corporate capital unimpaired by dividends or frauds.[63]

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[58] Cook, *Treatise on Law of Corporations,* 180, 206. He thought these problems explained why "even constitutional and statutory prohibitions against watered stock have been practically construed away by the courts," at least in so far as they concerned non-regulatory bodies.
[59] 1906/01 The Issue of Corporate Stock for Property Purchased – a New Phase, *Yale Law Journal*, Leonard Wallstein, 111-2, 119.
[60] 1910/05 John Adams Jr. Stocks and Their Features : AAAPSS, 525.
[61] 1924/05 James C. Bonbright "The Dangers of Shares without Par Value," *Columbia Law Review*
[62] 1924/05 James C. Bonbright "The Dangers of Shares without Par Value," *Columbia Law Review* 464, "the outstanding feature of corporations has now become, not limited liability but no liability."
[63] 1913/06 Victor Morawetz, *Harvard Law Review*, "Shares Without Nominal or Par Value," 731.

The no-par laws also did not end state legislative efforts on stock-watering. Besides the increase in Blue Sky laws and some public utilities laws noted earlier, the majority of states passed specific laws forbidding stock watering in the 1910s, and some updated their previous statutes. Pennsylvania's 1874 act on stock sales at par was amended in 1913 to include concerns about director liability and other issues.[64] In 1920 the economist James Bonbright said that even though removing par value would "do away with the possibility of deception which is the chief evil of stock watering," there were other evils that needed to be fought, namely, the investors still had to depend on valuations as stated by company.[65] For instance, the Idaho law of 1921 allowed no par value of stocks for the first time, but it required corporations to submit the total amount received for original stock sales, and forbid dividends out of that capital.[66] Without par value requirements to hold stock sales to some fixed amount, some states required corporations issuing stock for intangibles like patents to hold the stock in escrow until company earned profits.[67]

Federal interest in and regulation of stock-watering increased in the very years after no-par stock laws became common. The Federal Trade Commission itself had stock-watering as one of its impetuses. When Senator Francis Newlands, the progenitor of the commission, submitted a resolution to investigate interstate commerce issues in March 1913, the first question was whether the Sherman antitrust act should be amended to define specific restraints of trade, including "unfair competition, stock watering, overcapitalization" and other issues.[68] In the debates, one representative referenced the "publicity" given to corporation accounts and returns that the FTC would provide, and said that one of its main purposes would be to fight "overcapitalization." If "there is overcapitalization, 'that unjust burden upon our industrial and commercial existence,' such fact will become known by the return" to the FTC.[69] Another representative noted that "one of the greatest evils of the trust, aside from the destruction of competition, lies in overcapitalization" by the trust promoters.[70] Another

[64] Cook, *Treatise on Law of Corporations,* 219-220.
[65] 1920/03 James C. Bonright "The Basis of Railroad Capitalization," *Political Science Quarterly* 31. 1924/05 James C. Bonbright "The Dangers of Shares without Par Value," *Columbia Law Review*, 454.
[66] 1921/12 Par Value Verus No Par Value Stock, Henry E. Colton, ABA Journal, 673.
[67] 1928 Forrest Ashby, Finance Instructor, Wharton School, The Influence of Securities Regulation upon Standards of Corporation Financing MLR
[68] 50 Cong. 34, March 17, 1913.
[69] Bills and Debates in Congress relating to Trusts (Washington, GPO, 1914), 1308.
[70] 51 Cong. 14233, August 25, 1914,

representative said that the passage of the FTC law would "carry into effect our platform pledges" that the government investigate and regulate "all cases of material overcapitalization."[71]

The federal government also gained more substantial control over railroad stock issues. In 1920 the ICC finally gained the power to regulate and approve the offer of all interstate railroad stock. The Esch-Cummins bill was the result of advocacy by Representative John J. Esch, who had worked for regulation of securities for years.[72] As economist William Z. Ripley stated, "from the railroad point of view, also, the desirability of an enlargement of the scope of authority of the Interstate Commerce Commission" was obvious, since it could corral and preempt competing state commissions that also had stock approval. He mentioned that the reorganization of the Wabash railroad involved at least 6 state commissions approving security issues.[73] At the same time, the Federal Water Power Act of 1920, which set up a new Water Power Commission to regulate development of dams on federal rivers, brought accounting and public reports into affected utilities as well. The Commission hired an financial accountant from the ICC, and, as any early advocate pointed out, it required new standardization of capitalization accounting in the industry, including depreciation requirements.[74]

The increasing federal and state supervision of railroad and utility companies' issues was no minor increase in power. By some measures these classes of securities exceeded the amount of all other issues combined. Thus state and federal regulatory commissions were supervising the majority of new stock market issues long before the federal government began creating an independent body to regulate finance.[75]

The New Deal had a particular focus on investor protection, and many of the tools they used were imported from earlier railroad and utilities regulations.[76] The Securities and Exchange Commission, which first existed as a branch of the Federal Trade Commission, took much of its impetus from those earlier railroad and utility regulatory bodies. The same aim was to publicize companies' accounts and

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[71] 51 Cong. 8861, May 19, 1914
[72] 51 Cong. 9791, June 4, 1914.
[73] 1914/09 Public Regulation of Railroad Issues, William Z. Ripley, *American Economic Review*, 561-2.
[74] Morris Cooke, "The Federal Water Power Act and Its Administration (Confidential)," C. 1925, Felix Frankfurter Papers.
[75] 1928/04 Irwin S. Rosenbaum and David E. Lilienthal, Issuance of Securities by Public Service Corporations 716
[76] See Judge Glock, *The Dead Pledge: The Origins of the Mortgage Market and Federal Bailouts, 1913-1939* (New York: Columbia University Press, 2021).

ensure against inadequate capital. As Felix Frankfurter, one of the SEC designers, said after the passage of the first version in 1933, "The Securities Act is strong insofar as publicity is potent; it is weak insofar as publicity is not enough."[77] Even the creation of the Federal Communications Commission in 1934 had similar concerns. A combined executive and congressional committee on communications set up by President Franklin Roosevelt recommended the creation of the commission and noted as one of its benefits was that it "will prevent the 'watering' of stocks.""[78] The Public Utility Holding Company Act of 1935, and its famous "death sentence" of holding companies, were also aimed primarily at corporations who had grown through "watered" stock. In a speech on investor protection after passage of the act, President Franklin Roosevelt said that there was "no better example of the true meaning" of his program on investor protection than "the legislation regulating public utility holding companies," which was designed to prevent both "watered stock and high rates to consumers."[79]

Due to increasing state and federal supervision of stock issuance and publicity, the Democratic Party could declare victory over the stock-watering menace in 1952. While almost all stock had no par value now, politicians could claim the demise of the stock promoters offering the "blue sky" with no concrete capital behind an enterprise and the end of "overcapitalization." An increasing number of utilities and transportation companies could only change their rates and their stock and bond issuance at the sufferance of the state and federal governments, and almost all corporations had to submit reports and financial accounts to the state and federal governments.

The war on stock-watering birthed much of our modern administrative state. Many of the political issues from this battle, such as the correct level of capital and thus the correct rates of return for public utilities, and the correct amount of publicity for corporate affairs and securities issues, are still central in regulatory struggles today.

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[77] "Federal Securities Act" c. 1933, Felix Frankfurter Papers
[78] Secretary of Commerce to the President, "Study of Communications by an Interdepartmental Committee January 23, 1934," US Congressional Documents, Heinonline
[79] President Franklin Roosevelt, "Statement on Singing Two Statutes to Protect Investors," August 23, 1940, https://www.presidency.ucsb.edu/documents/statement-signing-two-statutes-protect-investors