RAILROAD CAPITALIZATION; A STUDY OF THE PRINCIPLES OF REGULATION OF RAILROAD SECURITIES. VOL. XCV. NUMBER 1. WHOLE NUMBER 215

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RAILROAD CAPITALIZATION

A Study of the Principles of Regulation of Railroad Securities

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PREFACE

When Congress included in the Transportation Act of 1920 a provision giving to the Interstate Commerce Commission full and exclusive control over the issue of securities by interstate carriers, it brought to a close one of the sharpest and most protracted controversies that have been waged in the field of railroad regulation. This controversy was concerned with the question of the public interest in railroad capitalization. For years, stock watering has been attacked in and out of Congress as one of the most vicious practices of private railway managements; for years, popular discussions have held it responsible for exorbitant rates and inefficient service. Yet, until recently, railway officials have insisted that neither stock watering nor any other form of overcapitalization is a matter of public concern; and, until recently, their views have prevailed with the lawmakers, to the extent, at least, of preventing public control. Now all this is changed. First the states, and at last the federal government have seen the necessity of financial control as a means of securing reasonable rates and adequate service.

But though the principle of public control is now a settled issue, the problems connected with this control are by no means settled. Railways, we say, should be properly capitalized. But what is proper capitalization? And how is it to be secured under government control? These are questions on which Congress and the Interstate Commerce Commission will have to spend much thought and effort. Success or failure in finding the correct answers will be one of the deciding factors in the larger issue of private *versus* government ownership.

The present work is a study of some of these problems. It makes no attempt to cover the entire subject of security regulation—a subject almost as intricate and comprehensive as the kindred subject of rate regulation—but confines itself to the more fundamental principles and the more important issues. Special attention is given to the problem of stock watering. Stock watering is an evil for which three very different remedies have been proposed. The first remedy is to prevent the practice by requiring that no shares be issued at less than their par value; the second is to allow stock watering to continue, but to render it harmless by giving full publicity to the actual investment; the third is to meet the problem by issuing shares of stock without par value. Or, to put it in other words, the first measure would make the par values indicate the true investment; the second would expose the par values as a pure fiction; the third would abolish par values entirely. Each of these three methods has won the support of eminent authority; each has been put into practice by various state governments. Which of the three should be adopted by the federal government is a problem discussed at length in the present study.

For a brief review of the points developed in this study, the reader is referred to the summary or conclusion at the end of each chapter. Chapter I analyzes the effect of capitalization on the rate level and on the quality of the service. An extended discussion of the relation between capitalization and rates seemed to be called for, not merely because of the wide differences of opinion which have hitherto prevailed on the subject, but also because of the practical bearing of this problem on the objects and methods of security regulation. The conclusion of the first chapter is that capitalization influences rates and services primarily through its effect on railway credit. Chapter II, therefore, considers precisely how capitalization may influence the corporate credit—to what extent overcapitalization weakens the financial structure. A discussion of the evil effects of overcapitalization naturally raises the question, What is proper capitalization? In Chapter III this problem is treated under the heading, "the Basis of Capitalization." A study of the experience of the various state commissions leads to the conclusion that the whole attempt to make capitalization correspond to the corporate assets is impracticable, and that it should be abandoned in favor of the plan of issuing shares of stock without par value. Chapter IV considers in detail this recent financial device and defends it against current criticisms. A concluding chapter is devoted to a discussion of three of the special problems connected with the federal regulation of railway securities.

The material for this study is drawn largely from the reports of decisions rendered by the various state public service commissions on the applications of public utility companies for permission to issue securities. State commissions are the pioneers in the field of security regulation, and their experience will serve as a guide to the federal government. In most states, control over security issues extends both to railways and to local public utilities, but the general principles involved are identical despite some differences in detail. Therefore, although the present treatise is written with special reference to the problem of the railways, the writer has not hesitated to cite as precedents decisions with respect to public utilities of all classes. In these citations, the abbreviation "P. U. R." refers to the *Public Utilities Reports, Annotated* (Rochester, N. Y., Lawyers Cooperative Publishing Company, 1915-   ).

Among the unofficial literature on the subject, the author owes much to the writings of Barron, Heilman, Ignatius, and Ripley. The last named author's work on *Railroads, Finance and Organization* has been a constant and valued companion in the preparation of this study. More specific references to the writings of these and other authors are given in the footnotes and in the bibliography at the end.

Several specialists have been kind enough to read parts of the manuscript. For this service the author is much indebted to Dr. John Bauer, and to Professors Henry R. Hatfield, Roy B. Kester, Hastings Lyon, T. W. Van Metre, and Allyn A. Young. Each of these men has made valued suggestions and criticisms resulting in the modification of manuscript. The study as a whole has been made under the direction of Professor Seligman. To him, most of all, the writer would express his deep gratitude for constant help and stimulating guidance.

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