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Findings and Opinions

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New York Supreme Court

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FINDINGS AND OPINIONS

Randall, Trustee of Bush Terminal Company v. Bailey, et al.

Review of Decision

New York Supreme Court
October 29, 1940

In *Randall as Trustee of Bush Terminal Company* v. *Bailey, et al.*, the plaintiff, as trustee in a proceeding for the reorganization of the Bush Terminal Company under the federal bankruptcy act, sued former directors of that company to recover dividends paid between the years 1928 and 1932, on the ground that such payments resulted in an impairment of the company's capital and were made in violation of section 58 of the New York State Corporation Law, which provides as follows: "No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital or capital stock as the case may be."

Although the company's books showed a surplus after the payment of the dividends in question, the plaintiff claimed that the dividends were improperly distributed for a number of reasons which the Court, in its opinion, reduced to the following:

1. It was improper to "write-up" the land values above cost, thereby taking unrealized appreciation into account.
2. It was improper not to "write-down" to actual value the cost of investments in, and advances to, subsidiaries and thereby fail to take unrealized depreciation into account.
3. It was improper to include as an asset an item so-called goodwill which the company carried at $3,000,000.
4. It was improper to include as an asset $492,958.30, being the cost of properties which had been demolished.*

In an exhaustive opinion, Mr. Justice Walter, of the New York Supreme Court, exonerated the directors (*New York Law Journal*, Tuesday, October 29, 1940). In arriving at this result he sustains the value of goodwill at $3,000,000 and the value of land at current market rather than cost; as to the remaining items, he holds that reductions should have been made although the maximum reduction (as claimed by the plaintiff) would not affect the result in view of the holdings with respect to land and goodwill. The decision will in all probability be appealed, but in the meantime, the opinion of the Court contains a good deal of material which is of interest to accountants and which may be summarized under the following headings:

1. The New York law with respect to restrictions on the payment of corporate dividends.
2. The nature of goodwill or "going-concern value," its elements, and its valuation for the purpose of determining the legality of dividends.
3. The valuation of fixed assets, such as land, for the same purpose, and particularly whether cost or present value should be used and whether appreciation should be recognized.
4. The valuation of investments in subsidiary companies for the same purpose, and particularly whether cost or present value should be used and whether depreciation (decline in value?) should be recognized.
5. The various methods of determining the value of property, the recognition of such values in the statements and books of account, and the duties of the directors with respect to balance-sheet values in connection with dividends.

Each of the foregoing phases of the decision will be discussed in turn.

The New York Statute

As Mr. Justice Walter points out, the legality of dividend disbursements *depends entirely upon the statute of the state of incorporation;* the basic problem in the case is therefore *entirely one of statutory construction.* There is no question as to the business acumen or financial sagacity of the directors; no point in considering sound economics, sound business judgment, proper financial policies or proper accounting practices; no use in attempting to generalize as to what the rule is or should be.

The New York statute is said to prescribe the "capital impairment" test; it provides that no stock corporation shall declare or pay any dividend which will *impair capital* or *capital stock,* nor *while* its *capital* or *capital stock* is *impaired.* The statute then goes on to say that no such corporation shall declare or

* This item appears to have been treated by the Court as part of the second question.

pay any dividend or make any distribution of assets, whether upon a reduction of the number of its shares or of its capital or capital stock, "unless the value of its assets remaining after the payment of such dividend or after such distribution, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital or capital stock as the case may be." A preliminary question is presented as to whether the phrase beginning "unless the value of its assets" is to be read as relating back to the beginning of the section and thus applying to *all* dividends and distributions, or whether it relates only to the specified situations where there is a reduction in the number of shares, etc. If it does relate back, Mr. Justice Walter says that the plaintiff obviously has no case. It is difficult to follow this reasoning, because if the phrase relates back, a further question remains as to the meaning of the word "value" which may not be answered by suggestions to the effect that it means "real" value, "true" value, "fair" value, etc. A practical basis of valuation still remains to be established. Mr. Justice Walter holds, however, that the section cannot be so read grammatically, and he treats the statute as if it provided simply that "no dividend shall be declared or paid which will impair capital or capital stock nor while capital or capital stock is impaired." The question, therefore, is what is meant by the terms "capital" and "capital stock," and what method of valuation is to be employed in determining whether there is an "impairment."

In this connection Mr. Justice Walter reviews the history of section 58, pointing out that originally, and for a great many years, it contained a provision to the effect that no dividend should be paid except from "surplus profits." He concludes that the elimination of this phrase in the 1923 revision indicates an intent upon the part of the Legislature to make available for dividends, capital resulting from sources *other than profits*, thereby preventing the very claim which is advanced in this case by the plaintiff. He also reviews the New York decisions as to the meaning of the terms "capital" or "capital stock" and concludes that these terms mean an amount, i.e., a value, of property up to the limit of the number of dollars specified as the par value of paid-up issued shares (or as the stated value of no-par shares), and that when the amount, i.e., the value, of the company's property exceeds that number of dollars, the excess, whether contributed by stockholders or otherwise obtained and including appreciation, may be distributed. In other words, impairment is to be determined by taking assets at their *present* values rather than at cost. He indicates that this view is supported by the decisions in *People ex rel. Wedgewood Realty Co.* v. *Lynch*, 262 N. Y. 202, 604, and *People ex rel. Mercantile Safe Deposit Co.* v. *Sohmer*, 158 App. Div. 110; by the decision in *Cox* v. *Leahy*, 209 App. Div. 313; by certain textbook writers; by certain New Jersey and North Carolina cases; and by *Edwards* v. *Douglas*, 269 U. S. 214.

The Wedgewood and Mercantile Safe Deposit cases involve the taxability of dividends and are scarcely in point; Cox v. Leahy is a dividend case but is not carefully considered; Edwards v. Douglas merely states as a fact that surplus may include increase resulting from the revaluation of fixed assets; any persuasive effect of this case is entirely offset by *La Belle Iron Works* v. *United States*, 256 U. S. 377, holding that appreciation may not be considered in determining invested capital.

Mr. Justice Walter also considers a number of cases in New York and other states taking a contrary view, including *Hill* v. *International Products Co.*, 129 Misc. 25; *Hutchinson* v. *Curtis*, 45 Misc. 484; *Jennery* v. *Olmstead*, 36 Hun. 536; *Kingston* v. *Home Life Insurance Co.*, 11 Del. Ch. 258; *Southern California Home Builders* v. *Young*, 45 Cal. App. 679; *Sexton* v. *Percival*, 189 Iowa 586; *Titus* v. *Piggly Wiggly Corp.*, 2 Tenn. App. 184. There are a great many additional cases, which might have been cited, holding that appreciation may not be recognized; as a matter of fact, the corporate laws in some of the states specifically prohibit its recognition. Taking the cases in the various states collectively, the general rule is definitely against the recognition of appreciation. While Mr. Justice Walter's decision may be sustained as a matter of statutory construction, it is clearly against the weight of authority of the case-law elsewhere.

As to Goodwill

At the time of its organization in 1902 the Bush Terminal Company issued $2,000,000 face amount of bonds and $3,000,000 par value of stock, receiving therefor a tract of land equipped with piers, warehouses, and other facilities, a lease of two piers, and certain services of Irving T. Bush. The latter owned or controlled Bush Company, Lim., which was then conducting a terminal enterprise on adjoining property and which in 1904 was acquired by Bush Terminal Company. The stock was not entered on the company's books at the time, but in 1905 it was entered as having been issued for goodwill which the directors valued at $3,000,000. It is not clear just what the company received for this stock, but this is not material since the decision turned on the value of the goodwill at the time of the dividend disbursements.

In his decision Mr. Justice Walter defines goodwill as "that element of value which inheres in the fixed and favorable consideration of customers arising from an established and well known and well conducted business." He then points out that it is analogous to what is known as "going concern value" in the public-utility cases which may be defined as "that element of value which inheres in an assembled and established plant, doing business and earning money over one not thus advanced." He concludes that the business built up by the Bush Terminal Company was such as to warrant a holding that the goodwill should be included as an asset at the indicated value at the time of the dividend payments.

The precise facts upon which Mr. Justice Walter arrives at this conclusion are not stated.

Both sides presented expert testimony as to the value of *the enterprise in its entirety* based on reproduction cost and capitalization of earnings. Values based on reproduction cost were not widely divergent and indicated no impairment. Values based on capitalized income, however, were in sharp contrast, and because of certain objections to the methods of the plaintiff's experts, the Court accepted the valuation of the defendant's expert which indicated no impairment of capital. It is to be noted in this connection that the valuation of the enterprise as a unit, particularly as a going concern, is to be preferred over valuation of individual assets, and that the decision can be sustained on this basis.

As to Land

The corporation owned certain land which cost $1,526,157.30. In 1915 and 1918 the company increased the land valuation to the amount of its then assessment for purposes of taxation, thereby recognizing appreciation of $7,211,791.72. This valuation of $8,737,949.02 was continued during the period in which the dividends were made, at which time it was less than the current assessed values, although in certain proceedings initiated by the receiver for revision of the tax assessments he contended for much lower values.

Having decided that appreciation may be recognized under the New York statute, Mr. Justice Walter states that the rule of valuation applicable to an asset like land is present value rather than cost. He states this as a general rule, although he might have reached the same conclusion on the ground that (a) land is an exception to the rule against recognition of appreciation, or (b) that appreciation may be recognized in exceptional cases where there is a substantial increase of market value over cost which seems to be permanent. The principal objection to this conclusion is that it involves an unsatisfactory method of approach; it deals with assets individually instead of considering the business as a unit.

As to Investments in Subsidiaries

The plaintiff contended that investments in subsidiary companies should be reduced to present values in order to take account of certain losses and declines in value. Mr. Justice Walter describes the plaintiff's position as "inconsistent" but he agrees with it on the ground that having recognized the appreciation of land, consistency requires the recognition of what he calls "unrealized depreciation" in the investment in subsidiary companies. Since accountants generally decline to recognize appreciation and are inclined to recognize substantial declines in value, the question arises as to whether there is any merit to the criticism of "inconsistency." Experience has shown that much harm may be done by the recognition of appreciation, while the recognition of declines in value is on the whole salutary. In one sense of the word at least, the accountant's procedure is therefore quite consistent.

As to Methods of Valuation

The decision reviews a number of methods of arriving at the present value of assets including expert or informed opinion, engineering appraisal, and capitalization of income, and is entirely sound in pointing out that these methods are rough approximations at best. In the capitalization-of-earnings method, for instance, comparatively slight differences in the basic assumptions lead to substantial differences in the result.

The Duties of Directors

Under the decision directors are required to consider and determine the value of the assets at each dividend declaration. Mr. Justice Walter points out, however, that this rule does not require directors to obtain a formal appraisal from professional appraisers at each dividend declaration, or that the values at the time of the dividend declaration be entered in the books. The directors must consider, he says, whether the cost of the assets reflects their "fair value"; they must exercise an "informed judgment." He does not, however, indicate very satisfactorily the precise scope of the duties of directors in this respect. The accountants may take comfort from the fact that their rule against the recognition of appreciation and their rules with respect to the recognition of losses of every kind and description *are the best rules for directors to follow*. It is true, of course, that dividends would be paid less frequently, but, by the same token, fewer suits would be brought against directors for improvident dividend declarations.

Conclusions

The statute relative to dividends is obviously intended to protect creditors. Under the capital-impairment text no distribution may be made unless assets remain sufficient to cover all liabilities and a margin equal to the amount of the legal capital or capital stock. The crux of the matter is, of course, the question of valuation. In order to protect creditors, the valuation should be made conservatively, i.e., in any approximation of value the tendency should be toward undervaluation rather than the contrary.

How shall the valuation be made? At the outset, decision must be made as to whether the various assets should be dealt with *individually* or whether they should be considered *collectively*. As to the former, balance-sheet values are important; as to the latter, it is income that counts. On the individual basis it is of course difficult to escape a consideration of present values, although appreciation must needs in any event be dealt with carefully. On the collective basis, however, cost may be taken with (a) an addition for goodwill if the earnings warrant, and (b) a deduction for decline in value if earning power is inadequate to support cost. When all is said and done, one comes back to the accounting rules as being least likely to result in injury. *Appreciation should not, except in extreme cases, be recognized,*

while full effect should be given to all losses sustained and all probable losses.

A final question may well be raised as to the efficacy of the capital-impairment test as a method of controlling dividend disbursements. Would it not be preferable to formulate a rule requiring that the directors exercise sound business judgment under all of the circumstances, or a rule that dividends be limited to distributions of earnings? If, under such a rule, the directors saw fit or found it desirable to distribute other than earnings, or if they were in doubt as to the legality of the disbursement, they could file the necessary amendment to the certificate of incorporation, thereby notifying creditors and giving them an opportunity to protect their rights.

JAMES L. DOHR

National Electric Signal Company

REVIEW OF DECISION

In the matter of the National Electric Signal Company, securities act of 1933, release No. 2387 (November 6, 1940), the Securities and Exchange Commission issued a stop order suspending the effectiveness of the registration statement on the ground that it included untrue statements of material facts and omitted to state material facts required to be stated or necessary to make the statements therein not misleading. Among the deficiencies, the Commission found that the accountant's certificate did not comply with rule 651.

The certifying accountant testified that he was employed to "straighten out" the books; that he had not made an audit; that the financial statements merely reflected the facts as shown by the books and were prepared without adequate verification; that certain items in the balance-sheet had been improperly classified; that the bank balance had not been properly reconciled and that he was unable to reconcile it. None of these facts was disclosed in his certificate. Obviously the certificate failed to comply with the Commission's rules.

In addition to the foregoing, the accountant's certificate was signed by him as a certified public accountant, although he was not a certified public accountant under the laws of the State of Texas (where the company was located and where the work was done), nor did the record indicate that he was a certified public accountant in any other state. He testified that he had acquired a certificate in 1925 to the effect that he had passed an examination given by the National Association of Certified Public Accountants, and that in 1926 he had had a conversation with the chairman of the State Board of Public Accountancy of Texas, who had told him that his "certificate was sufficient." The courts in Texas, as elsewhere, have held that the use of such a certificate is a misdemeanor. *Henry* v. *State*, 260 S.W. 190; *Crow* v. *State*, 260 S.W. 573. In view of the history of the National Association of Certified Public Accountants and its members, it is rather surprising that anyone would attempt at this late date to style himself as a certified public accountant on the basis of one of its certificates.

JAMES L. DOHR

Investment Company Act Rule

SECURITIES AND EXCHANGE COMMISSION
Investment Company Act of 1940
Release No. 5—October 30, 1940

The Securities and Exchange Commission today announced the adoption of a rule relating to securities placed in the custody of a company which is a member of a national securities exchange by any management investment company registered under the investment company act of 1940. The rule is tentative in nature and has been promulgated to govern such custody during the time necessary to study and determine to what extent further regulation of the subject may be essential.

With appropriate exceptions, the rule provides in effect that the member firm acting as custodian must clearly earmark and segregate such securities; that the firm may not hypothecate or pledge such securities except for the account of the investment company; and that the firm may have no lien on those securities for any purpose. Provision is also made that the securities shall be subject to verification by an independent public accountant and by the Commission.

The text of the Commission's action follows:

"Acting pursuant to the investment-company act of 1940, particularly sections 38 (a) and 17 (f) thereof, and deeming such action appropriate to the exercise of the powers conferred and the duties imposed upon it in said act, the Securities and Exchange Commission hereby adopts rule N-17F-1 to read as follows:

"RULE N-17F-1—Custody of securities with members of national securities exchanges.

"(a) No registered management investment company shall place or maintain any of its securities or similar investments in the custody of a company which is a member of a national securities exchange as defined in the securities-exchange act of 1934 (whether or not such company trades in securities for its own account) except pursuant to a written contract which shall have been approved, or if executed before January 1, 1941, shall have been ratified not later than that date, by a majority of the board of directors of such investment company.

"(b) The contract shall require, and the securities and investments shall be maintained in accordance with the following:

"(1) The securities and similar investments held in such custody shall at all times be individually segregated from the securities and investments of any other person and marked in such manner as to clearly identify them as the property of such registered management company, both upon physical inspection thereof and upon examination of the books of the custodian. The physical segregation and marking of such securities and investments may be accomplished by putting them in separate containers bearing the name of such registered management investment company or by attaching tags or labels to such securities and investments.

"(2) The custodian shall have no power or authority to assign, hypothecate, pledge or otherwise to dispose of any such securities and investments, except pursuant to the direction of such registered management company and only for the account of such registered investment company.

"(3) Such securities and investments shall be subject to no lien or charge of any kind in favor of the custodian or any persons claiming through the custodian.

"(4) Such securities and investments shall be verified by actual examination at the end of each annual and semiannual fiscal period by an independent public accountant retained by the registered management investment company, and shall be examined by such accountant at least one other time, chosen by him, during the fiscal year. Certificates of such independent public accountant stating that he has made an examination of such securities and investments, and describing the nature of the examination, shall be transmitted to the Commission promptly after each such examination.

"(5) Such securities and investments shall, at all times, be subject to inspection by the Commission through its employees or agents.

"(6) The provisions of (1), (2) and (3) shall not apply to securities and similar investments bought for or sold to such investment company by the company which is custodian until the securities have been reduced to the physical possession of the custodian and have been paid for by such investment company, *provided* that the company which is custodian shall take possession of such securities at the earliest practicable time. Nothing in this subparagraph shall be construed to relieve any company which is a member of a national securities exchange of any obligation under existing law or under the rules of any national securities exchange.

"(c) A copy of any contract executed or ratified pursuant to paragraph (a) shall be transmitted to the Commission promptly after execution or ratification unless it has been previously transmitted.

"(d) Any contract executed or ratified pursuant to paragraph (a) shall be ratified by the board of directors of the registered management investment company at least annually thereafter.

"The foregoing action becomes effective November 1, 1940."