



1947

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Recommended Citation

John R. Carrell, *Fixing the Value of Consideration for the Issue of Stock*, 1 Sw L.J. 245 (1947)
<https://scholar.smu.edu/smulr/vol1/iss2/8>

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FIXING THE VALUE OF CONSIDERATION FOR THE ISSUE OF STOCK

THE nineteenth-century era of corporate expansion provided great impetus to the practice of "stock watering."¹ The lack of restrictions on corporate activity during this period and the resulting ease with which stock could be watered caused the several states to enact statutes and adopt constitutional provisions which attempted to restrict the consideration for the issue of stock to certain named classifications. Texas was no exception, and Article XII, § 6 of the Constitution of 1876 provides that "No corporation shall issue stock or bonds except for money paid, labor done or property actually received, and all fictitious increase of stock or indebtedness shall be void."² The Legislature soon found that this provision was not effective to prohibit corporations from watering stock and made an attempt to fix the amount of the consideration which must be received in payment for stock. These provisions are now incorporated in articles 1308 and 1353 of the Texas Revised Civil Statutes.³ It is the purpose of this note to determine, by analysis of the scope and operation of these

¹ "Watered" stock is stock issued for a bonus or otherwise without consideration, or for a less sum of money than the par value, or for labor, services, or property, which at a fair valuation is less than the par value." *Thomason v. Miller*, 4 S. W. (2d) 668, 670 (Tex. Civ. App. 1928).

² "Issued," as used in the above article, means delivered. *Zapp v. Spreckels*, 204 S. W. 786 (Tex. Civ. App. 1918); *Smith v. McAdams*, 206 S. W. 955 (Tex. Civ. App. 1918); *In O'Bear-Nester Glass Co. v. Antiexplor. Co.*, 101 Tex. 432, 108 S. W. 967, 109 S. W. 931 (1908), the Supreme Court said: "The purpose of the convention in enacting that provision of the Constitution was to secure creditors as well as stockholders of corporations against the practice which was too common of corporations issuing fictitious stock and stock upon an insufficient consideration, whereby the actual capital was much less than the amount represented by the shares issued and sold by the corporation. The terms in which this section of the Constitution is expressed indicated the purpose that the assets of the corporation should be something substantial, and of such a character that they could be subjected to the payment of claims against the corporation as well as to secure the shareholders in their rights in the capital stock." 108 S. W. at 968.

³ *TEX. REV. CIV. STAT. ANN.* (Vernon, 1925) arts. 1308, 1353.

provisions, whether they are effective or were, and remain, too general in character to accomplish their aim.

The problems arising under such provisions of what constitutes "labor done" or "property actually received" and of what value to affix thereto remained for the courts. In view of the very nature of the problems presented, it is not surprising that the decisions of the courts have not been harmonious. The provision as to money payment presents no real difficulty so long as the money is actually paid before the stock is issued.⁴ In construing the phrase "labor done" the Texas courts have held that the services of an attorney in aiding the corporation will support a stock issue under the Constitutional provision.⁵ On the other hand the services of a promoter rendered prior to the incorporation have generally been held not to amount to valid consideration for the issue of stock.⁶ And to much the same effect would be any agreement to render services in the future.⁷ With reference to "property actually received" the courts have held that a franchise,⁸ oil lease,⁹ secured note,¹⁰ contract of value such as an option con-

⁴ Stock may not be issued until the purchaser's contract to pay has been fully performed. *Turner v. Cattleman's Trust Co.*, 215 S. W. 831 (Tex. Civ. App. 1919); *San Antonio Irrigation Co. v. Deutschmann*, 102 Tex. 201, 105 S. W. 486 (1907), rev'd, 102 Tex. 201, 114 S. W. 1174 (1908).

⁵ *Stevens v. Episcopal Church History Co.*, 140 App. Div. 570, 125 N. Y. Supp. 573 (1910); *Hackney v. York*, 18 S. W. (2d) 923 (Tex. Civ. App. 1929).

⁶ *Cooney v. Arlington Hotel Co.*, 11 Del. Ch. 286, 101 Atl. 879 (1917); *Stevens v. Episcopal Church History Co.*, 140 App. Div. 570, 125 N. Y. Supp. 573 (1910); *Weatherford, M. W. & N. Ry. v. Granger*, 86 Tex. 350, 24 S. W. 795 (1894). But see (1937) 15 Tex. L. Rev. 464, 472 suggesting that the TEXAS SECURITIES ACT §§ 5(d), 7, approves such a practice.

⁷ *Cooney Co. v. Arlington Hotel*, 11 Del. Ch. 286, 101 Atl. 879 (1917); *McCombs Producing and Refining Co. v. Ogle*, 200 Ky. 208, 254 S. W. 425 (1923); *Lothrop v. Gowdeau*, 142 La. 342, 76 So. 794 (1917); *B and C Electrical Const. Co. v. Owen*, 176 App. Div. 399, 163 N. Y. Supp. 31 (1917); *Morgan v. Bon Bon Co.*, 165 App. Div. 89, 150 N. Y. Supp. 668 (1914); *Stevens v. Episcopal Church History Co.*, 140 App. Div. 570, 125 N. Y. Supp. 573 (1910).

⁸ *Barthold v. Thomas*, 210 S. W. 506 (Tex. Com. App. 1919).

⁹ *Cassidy v. Horner*, 86 Okl. 220, 208 Pac. 775 (1922); *McAlister v. Eclipse Co.*, 128 Tex. 449, 98 S. W. (2d) 171 (1936); *Peden Iron and Steel Co. v. Jenkins*, 203 S. W. 180 (Tex. Civ. App. 1918) (e.r.).

¹⁰ *Sohlund v. Baker*, 15 Del. Ch. 431, 141 Atl. 277 (1927); *Harn v. Smith*, 85 Okl. 137, 204 Pac. 642 (1922); *Cole v. Adams*, 92 Tex. 171, 46 S. W. 790 (1898); *Lone Star Life Ins. Co. v. Shield*, 228 S. W. 196 (Tex. Com. App. 1921); *Lumpkin v. Brown*, 229

tract,¹¹ and patents¹² come within Article XII, § 6 of the Constitution and similar provisions in other jurisdictions. Some items are deemed by the courts to have such an uncertain and speculative value as not to constitute "property actually received," e.g., an unsecured note,¹³ unpatented formulas,¹⁴ trade-marks,¹⁵ inventions of a highly speculative nature,¹⁶ and the use of a name, prestige or influence of an individual.¹⁷

A difficulty for the courts even greater than that of determining the acceptability of the various types of consideration for stock is that of the methods to be used in deciding whether to accept or reject the valuation placed by the directors upon the property thus received. The majority of jurisdictions, including Texas, have committed themselves to the so-called "good faith" test when

S. W. 498 (Tex. Com. App. 1921); Prudential Life Ins. Co. of Texas v. Pearson, 222 S. W. 967 (Tex. Com. App. 1920); Brownfield State Bank v. Hudson, 73 S. W. (2d) 140 (Tex. Civ. App. 1934); Penland v. Schramm, 232 S. W. 359 (Tex. Civ. App. 1921); General Bonding and Casualty Ins. Co. v. Mosely, 110 Tex. 529, 222 S. W. 961 (1920).

¹¹ General Bonding and Casualty Ins. Co. v. Mosely, 110 Tex. 529, 222 S. W. 961 (1920); Cole v. Adams, 92 Tex. 171, 46 S. W. 790 (1898).

¹² Atlas Trailers and Water Mufflers v. McCallum, 12 S. W. (2d) 957 (Tex. Com. App. 1929) and cases cited therein.

¹³ Thompson v. First State Bank of Amarillo, 109 Tex. 419, 211 S. W. 977 (1919); *aff'g* 189 S. W. 116 (Tex. Civ. App. 1916); Washer v. Smyer, 109 Tex. 398, 211 S. W. 985 (1919); Bank v. Spencer, 244 S. W. 123 (Tex. Com. App. 1922); Rouseau v. Everett, 209 S. W. 460 (Tex. Civ. App. 1919); Kanaman v. Gahagan, 185 S. W. 619 (Tex. Civ. App. 1916); Mason v. First National Bank of Paint Rock, 156 S. W. 366 (Tex. Civ. App. 1913).

¹⁴ O'Bear-Nester Glass Co. v. Antiexplor Co., 101 Tex. 431, 108 S. W. 967, 109 S. W. 931 (1908).

¹⁵ "In the case of a trade mark, whether assignable or not, the difficulties which would confront you in ascertaining its money value need not be dwelt upon, because such a value, however great or small it may be, is practically unascertainable." (1916-1918) BIENNIAL REPORT OF THE ATTORNEY GENERAL OF TEXAS 233, 236, op. 1867.

¹⁶ In O'Bear-Nester Glass Co. v. Antiexplor Co., 101 Tex. 431, 108 S. W. 967, 969 (1908), it was stated that "The qualified property right of the discoverer of an unpatented formula, is of such a character that it constitutes no substantial property, and could not under any circumstances be subjected to the payment of the debts of the corporations, nor could the shareholders have it sold and the proceeds distributed by process of court. Such unsubstantial and shadowy right when delivered in payment of stock constitutes no payment within the terms of the above quoted section of our Constitution."

¹⁷ Bowen v. Imperial Theatres, 13 Del. Ch. 120, 115 Atl. 918 (1922); B and C Electric Const. Co. v. Owen, 176 App. Div. 399, 163 N. Y. Supp. 31 (1917); Webster v. Webster Refining Co., 36 Okl. 168, 128 Pac. 261 (1912).

questioning the acts of the directors,¹⁸ *i.e.*, these courts accept the valuation made by the directors as conclusive if made in good faith. A minority of courts have used as a standard the "true value" rule which supposedly ignores the good or bad faith of the directors, as the case may be, and presents instead the question of whether the property is actually worth the value placed upon it by the directors.¹⁹

Whether the "good faith" or the "true value" standard be adopted by the court in reviewing the acts of the directors where there is an allegation of fraud or that the valuation by the directors was unreasonable, it still remains for the courts in some manner to define the term "value." Texas, in article 1308,²⁰ requires that the stock may be issued for the "actual value at which it was taken or at which the property was received." Other states having similar provisions use such terms as "value,"²¹ "fair value,"²² and "market value."²³ These formulae, with the possible exception of market value, do not of themselves indicate to the attorney

¹⁸ *Coit v. Gold Amalgamating Co.*, 119 U. S. 343 (1886); *Kaye v. Metz*, 186 Cal. 42, 198 Pac. 1047 (1921); *Home Savings Bank of Los Angeles v. Los Angeles City Realty Co.*, 176 Cal. 731, 171 Pac. 290 (1917); *U. S. Cast Iron Pipe and Foundry Co. v. Henry Vogt Mach. Co.*, 182 Ky. 473, 206 S. W. 806 (1918); *New Bern Tire Co. v. Kirkman and Cobb*, 193 N. C. 534, 137 S. E. 585 (1927); *Clevenger v. Moore*, 71 N. J. Law 148, 58 Atl. 88 (1904); *Krebs v. Oberrender*, 274 Pa. 154, 118 Atl. 19 (1922). That intentional overvaluation is fraud as a matter of law, see *Kaye v. Metz*, *supra*; *Zierath v. Claggett*, 46 Cal. App. 15, 188 Pac. 837 (1920); *Bryson v. Conlen*, 104 N. J. Eq. 180, 144 Atl. 723 (1929); *Atwell v. Schmitt*, 111 Or. 96, 225 Pac. 325 (1924). For cases admitting gross overvaluation as evidence of fraud, see *Zierath v. Claggett*, *supra*; *Compton v. Perkins*, 144 Or. 346, 24 P. (2d) 670 (1933).

Peden Iron and Steel Co. v. Jenkins, 203 S. W. 180 (Tex. Civ. App. 1918), advocates the good faith test while *Cole v. Adams*, 92 Tex. 171, 46 S. W. 790 (1898) followed the true value test. Since the *Peden Iron and Steel* case was the later decision, it would appear that Texas could now be classified as a "good faith" state. But see 2 HILDEBRAND, TEXAS CORPORATIONS (1942) § 304, where it is contended that *Cole v. Adams* states the Texas position.

¹⁹ *Bobb v. Walmar Theater Co.*, 206 Mo. App. 236, 227 S. W. 841 (1921); *Sheppard v. Larkin*, 226 S. W. 1021 (Mo. App. 1921); *Electromatic Cooling Co. v. Milne-Ryan-Gibson, Inc.*, 160 Wash. 320, 294 Pac. 1113 (1931); see *Hastings v. Scott*, 248 S. W. 973 (Mo. App. 1923), where latitude was allowed in arriving at value of property difficult of determination.

²⁰ TEX. REV. CIV. STAT. ANN. (Vernon, 1925) art. 1308.

²¹ ME. REV. STAT. (1944) c. 49, § 18; N. C. GEN. STAT. (1943) c. 55, § 55-63.

²² MINN. STAT. (1945) c. 301, § 301.15.

²³ KY. REV. STAT. (1946) c. 271, § 271.175.

or the courts how the meaning of the statutory term is to be determined nor what is to be taken into consideration in the valuation of the property received or labor done. Nor has the Securities and Exchange Commission attempted to set a standard of value; as aptly stated by Mr. Bonbright, "The commission has not undertaken to define 'value' or to dictate the methods of valuation. Instead, it insists that the appraiser himself explain what he means by the term, without dodging the issue by resort to misleading undefined phrases like 'sound value'."²⁴

If the item in question has an ascertainable market value, this might well be used as the true test of value. The Texas Court of Civil Appeals, in *Peden Iron and Steel Co. v. Jenkins*, where the problem was one of fixing the value of an oil lease, made the following statement:

"It is further argued, and with apparent truth, that the general rule is that the true test of the value of a thing is what it will bring on the market. But, to constitute market value, it must appear that similar things have been bought and sold in the way of trade in sufficient quantity or frequency to establish a market value for such things; that, where there is no market value for the thing, its value must then be ascertained by the circumstances of the case, the intrinsic value of the thing, the cost of it, its uses, the price asked and offered for it, and, indeed, any facts which would naturally affect the mind of parties buying or selling in determining the price asked or given."²⁵

Thus, where there is an ascertainable market value the court will admit testimony establishing that value according to the prevailing rules of evidence. This testimony will usually be as to the price for which similar property is selling in the particular locality.²⁶

²⁴ 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 809, n. 23.

²⁵ 203 S. W. 180, 182 (Tex. Civ. App. 1918).

²⁶ *Phillips Petroleum Co. v. Bynum*, 155 F. (2d) 196 (C. C. A. 5th, 1946); *Loud v. Solomon*, 188 Mich. 7, 154 N. W. 73 (1915); *Peden Iron and Steel Co. v. Jenkins*, 203 S. W. 180 (Tex. Civ. App. 1918). "Where the other sales were sufficiently near in time, and the other land was located sufficiently near the land in question and was sufficiently alike with respect to character and improvements to make it clear that the price paid for such tracts has probative value in determining the value of the land in question, the other sales are received by most courts." MCCORMICK AND RAY, TEXAS LAW OF EVIDENCE

If the market value of the property cannot be determined, then the court will have to resort to a determination of the actual value. It has been said that "Actual value or intrinsic value may not be shown unless it first be shown that there was no market price established by comparable sales."²⁷ In its determination of the actual or intrinsic value the difficulties with which the court is faced are at times insurmountable, and it is not surprising that there is yet no standard of value which is applicable in every case. The courts have, however, considered the items mentioned in *Peden Iron and Steel Co. v. Jenkins* as evidence of value and have then "totalled" these items, assuming this "total" would be the proper valuation for the property given in exchange for the stock in the case to be decided. The first of these items of evidence might well be classified as "cost,"²⁸ which could be broken down into several sub-classifications such as "original cost of the property," "cost of reproducing the property," and "cost to the promoter." Although these classifications have not received equal weight in the eyes of the courts as items of evidence, they have all been used in the attempts to arrive at a proper valuation of the property.

The original cost of the property would have little weight in the determination if other evidence were available, inasmuch as the court is concerned with the value of the property at the time of the exchange for the stock of the corporation and not at the time of the original investment. This becomes apparent when there has been a considerable lapse of time between the date of purchase and the date of the exchange. The use of this item as conclusive evidence of overvaluation of the property when there is

(1937) § 699. "Questions of degree of similarity and nearness of time and distance necessary to render testimony of sales of other property admissible to show value of condemned property is not determined by inflexible rule, but rests largely in the discretion of the trial judge." *City of Houston v. Pillot*, 73 S. W. (2d) 584 (Tex. Civ. App. 1934).

²⁷ *Phillips Petroleum Co. v. Bynum*, 155 F. (2d) 196, 201 (C. C. A. 5th, 1946); see *Babbitt v. Read*, 215 Fed. 395, 415 (S. D. N. Y. 1914), where the court states that "Value, of course, means market value."

²⁸ For a complete and exhaustive treatise on valuation and particularly a discussion of "cost" in general, see *DODD, STOCK WATERING* (1930) 111.

a wide discrepancy between original cost and the exchange price to the corporation would result in an unjust hardship on the corporation as well as on the promoter, this hardship being especially apparent during times of rapid price fluctuation. It is only when the original purchase and the transfer occur within a short period of time or when no material change in economic conditions has occurred that the original cost of the property may be taken to be the present value of that property. The Securities and Exchange Commission has apparently used original cost as an item of evidence in valuing property.²⁹

In considering the cost of reproduction as evidence of value it is necessary to arrive first at some understanding as to what is meant by the term "reproduction cost." Does it mean the cost of reproducing the exact item of property? Or does it mean the cost of reproducing an item which will render an equivalent service? The value established for the item will not be the same under the two meanings when there have been technological advances made in the particular field under consideration.³⁰ In a determination whether there was a overvaluation at the time of exchange for stock in the corporation, the term would necessarily have to mean the cost of reproducing the exact item. If so, the question would then arise whether this cost could properly be used to determine the present value of the property? If this inquiry is answered in the affirmative, it then becomes necessary to arrive at the cost of reproduction at the time the property was exchanged for the stock in the corporation, which due to the lapse of time since the exchange may prove difficult to such an extent as to be impractical. And even if these difficulties can be met and overcome, the test would be useful only in regard to those properties which are capable of reproduction. There are items such as patents and oil leases which are considered as property and which are at the same time practically incapable of being reproduced. Thus an attempt to

²⁹ In the Matter of Winnebago Distilling Company, 6 S. E. C. 926 (1940).

³⁰ TAYLOR, FINANCIAL POLICIES OF BUSINESS ENTERPRISE (1942) 614.

apply the test of cost of reproduction to such items would be an impossible task. It has been contended, however, by at least one court that, where property is capable of reproduction, the "cost of the physical reproduction is the test."³¹ It may be suggested that this test should never be made conclusive if other evidence is available in view of the failure of such a test to take into consideration the possible uniqueness which the particular property may have had to the corporation involved.

Where a promoter has purchased the property and then transfers it to the corporation in exchange for stock, the cost to the promoter should be considered but not made conclusive except in those instances where the discrepancy between the price paid by him and the price at which he exchanged the property for stock is so excessive as to make it appear that the promoter was taking unfair advantage of the corporate needs. The profit derived by the promoter in such an exchange must be within the limits of reasonableness or the court will consider such profit strong evidence of bad faith and consequently will hold the property to be overvalued if no other evidence is available.³² This is true particularly in those cases where the promoters are later the directors of the corporation and sell the property to themselves in exchange for paid-up stock.³³ As in the case of reproduction cost this type of evidence, if made conclusive, does not take into consideration the possible uniqueness of the property to the corporation; yet this is an item which the directors consider when valuing the property and which should properly be considered by the courts.

Thus it would seem that "cost" in general should be considered by the court in its valuation of the consideration exchanged for stock, but that it should not be made conclusive except in those cases where no other evidence is available; and even then due regard should be given to the uniqueness of the item as well as

³¹ See *v. Heppenheimer*, 69 N. J. Eq. 36, 61 Atl. 843, 847 (1905).

³² *In re Phoenix Hardware Co.*, 249 Fed. 410 (C. C. A. 9th, 1918).

³³ *Atwell v. Schmitt*, 111 Or. 96, 225 Pac. 325 (1924).

to the enthusiasm of the directors or the promoters, as the case may be.

In considering earning capacity as an item evidencing the value of property to be exchanged, it is necessary to classify the property exchanged depending upon whether the property has demonstrated that it has an earning capacity or whether the property has not yet made a "return," as in the case of a mine which has not been tested. In cases involving property of the first class there would seem to be no doubt that earning capacity should be a factor to be considered in valuing the property. Should the estimated future earning capacity also be considered as well as the past and present earning capacity? Evidently this would be considered where the past and present earning power has been established. As was said by the New Jersey Court of Chancery in *Railway Review v. Groff Drill and Machine Co.*,

'It may be assumed, as held in *See v. Hoppenheimer*, 69 N. J. Eq. 36, 61 Atl. 843, that prospective profits, arising from the new conditions created by the transfer, are not elements that can be considered in ascertaining value for which stock can be issued. But it cannot be doubted that established past and present earning capacity may be made a proper basis of valuation in appropriate circumstances. . . . Nor is it possible for any intelligent purchaser to wholly disregard future prospects. While our statute may not contemplate the capitalization of prospective future profits, it is clear that no present earning capacity can be made the intelligent basis of valuation without due consideration of future profits; but where there are prospects of increased future earning capacity, the present earning capacity demonstrated by actual operation clearly affords a proper basis of valuation of a business of this peculiar nature, if the future prospects are not also capitalized."³⁴

The *Railway Review* case involved the valuation of a patent to be used on railroads and which was already standard on other roads, thus making a determination of the past and present earning capacity relatively simple.³⁵

As to cases involving property from which there has been no

³⁴ 84 N. J. Eq. 321, 91 Atl. 1021 (1914), *aff'd*, 96 Atl. 1103 (1915).

³⁵ *Grant v. East and West R. R. of Ala.*, 54 Fed. 569 (C. C. A. 5th, 1893).

past or present earning derived, the court is hesitant to consider the possibility of such future profits. Vice-Chancellor Leaming in the case of *Wolcott v. Waldstein*, in which it was sought to place a value on property which had been considered by the directors in the light of estimated earning capacity, made the observation that

"The nearest approach to a justification of the valuation placed upon the property is to be found in the claim that the circumstances which existed at the time the valuation was determined upon may have justified a reasonable expectation that the corporation under proper management would develop an earning capacity proportionate to its capitalization. Future prospects or prospects of future profits can never be properly ignored in any intelligent valuation of property; but it is well settled that under our statute such prospective future profits cannot be made the basis of valuation for purposes of capitalization in a new enterprise with neither present nor demonstrated earning capacity."³⁶

It would seem that any inquiry as to the earning capacity of an item which has not demonstrated its capacity to earn would be of such a speculative nature as not to warrant reliance by the court in its determination of value. This would seem necessary in view of the inability thus far of society to eliminate or control the business cycle with its periods of depression and prosperity and with no known method of forecasting when the cyclical changes will occur. Under such a system the promoters and the directors might put great faith in the earning capacity of a certain article while in the midst of a short-lived period of prosperity which is creating at the moment a great demand for the article or service they are marketing.

The valuation of mines presents a problem in which a certain

³⁶ 86 N. J. Eq. 63, 97 Atl. 951, 952 (1916); *Hasson v. Koeberle*, 180 Cal. 359, 181 Pac. 387, 390 (1919), where the court said that "... it is evident that future earning capacity rather than present cash value was adopted as a standard. We do not mean to say that prospective earning capacity, properly subordinated to other modes of ascertaining value, may not be considered in determining present cash value. We are compelled to conclude, however, that the court adopted a prospective earning power as the standard of value, and did not consider it as merely some evidence of present cash value which upon a review of the cases we take to be the standard approved by them."

amount of speculation would have to be involved in any criteria of value that may be accepted.³⁷ Fixing the value of this type of property involves a question of hypothetical exchange: What would a reasonably prudent purchaser, under the circumstances, be willing to pay for the property?³⁸ It was said in the early Illinois case of *Tuck v. Downing* and is, for the most part, true today that

"No man, however scientific he may be, could certainly state how a mine, with the most flattering outcrop or blowout, will finally turn out. It is to be fully tested and worked by men of skill and judgment. Mines are not purchased and sold on a warranty, but on the prospect. The sight determines the purchase. If very flattering, a party is willing to pay largely for the chance. There is no other sensible or known mode of selling this kind of property. It is, in the nature of things utterly speculative, and everyone knows the business is of the most fluctuating and hazardous character. How many mines have not sustained the hopes created by their outcrop!"³⁹

The courts, however, do not accept a naked speculation as evidence but will require some evidence to support the contentions of the promoters or directors as to the value.⁴⁰ What then should comprise this evidence? The Securities and Exchange Commission evidently requires an appraisal by a qualified engineer or one otherwise qualified. In the *Matter of Great Dike Gold Mines, Inc.*, the Commission, in commenting on the value of the mine as estimated by an accountant without experience as an appraiser of gold mining property, said that the report of the engineer "was not

³⁷ *Clinton Mining and Mineral Co. v. Jamison*, 256 Fed. 577 (C. C. A. 3rd, 1919); *Hyams v. Calumet and Hecla Mining Co.*, 221 Fed. 529 (C. C. A. 6th, 1915).

³⁸ *Hasson v. Koeberle*, 180 Cal. 359, 181 Pac. 387, 390 (1919): "It was the duty of the court to determine this value by ascertaining as nearly as possible what a reasonably prudent investor who contemplated spending his own money would have been willing to pay for the Ord Mountain claims under the circumstances under which the corporators acted on the date of the transfer."

³⁹ 76 Ill. 71, 94 (1875).

⁴⁰ In *Babbitt v. Read*, 215 Fed. 395, 416 (S. D. N. Y., 1914), where the problem was the valuation of coal property, the court said: "But the difficulty is that there is no proof in this regard as to what, if any, increase in value, as such, there was between the units considered separately and these units when aggregated into a field of 47,000 acres; and plaintiff is right when he insists that the evidence fails to show a basis upon which added combination value may be figured."

made upon the basis of any examination by sampling; and according to [his] testimony may have been made merely after he had 'just superficially glanced at it'.⁴¹ Regarding the elements of an appraisal, the Commission, in the *Matter of Breeze Corporation*, said that

"If an appraisal, or a representation of value purportedly based thereon, is not to be misleading, the appraisal must meet two tests. In the first place, as we have observed in a previous opinion, 'an appraisal purports to be more than an arbitrary determination of value. It seeks to attach value to objects as a consequence of method.' In the matter of Haddam Distillers Corporation, 1 S.E.C. 37, 42 (1934). In other words, it is misleading to represent as an appraisal a valuation which is not based solely on scientific method, but which rests in whole, or even in part, upon foundations that are arbitrary or capricious. In the second place, there must be a fair and accurate application of the methods purported to be followed. . . . The fact that valuations are in the final analysis expressions of judgment does not warrant a departure from these standards."⁴²

In placing a value on a patent, an engineer employed by the Securities and Exchange Commission testified

" . . . that there were four accepted bases for appraising a patent, viz., (1) the amount of an actual cash sale between parties dealing at arm's length with each other; (2) the amount of a bona fide cash offer to purchase made by a financially responsible person; (3) a capitalization of the royalties obtained from a patent; and (4) a capitalization of those earnings of a company that were strictly attributable to a patent. He testified that in the absence of information upon which one of the foregoing criteria of value would be applied, any value given to a patent would not be an appraisal in the technical sense, but would be a guess, and that in such case, it was impossible to assign more than a nominal value to a patent. The assignment of value to a patent application as distinguished from a granted patent presents an *a fortiori* case, since there is involved the additional contingency that letters patent may never be issued."⁴³

Thus the problem of fixing the value of the consideration for the issue of stock or of reviewing the valuation after it has been

⁴¹ 1 S.E.C. 621, 626 (1936).

⁴² 3 S.E.C. 709, 717 (1938).

⁴³ In the *Matter of Peterson Engine Co., Inc.*, 2 S.E.C. 893 (1937).

established by the corporation is a matter of particular cases depending on the nature of the subject matter involved, and no single principle or standard can be said to be applicable in every case. The proper valuation, in the final analysis, is a matter of bargain and exchange between the parties interested in the transaction, and it is only where one or more of the parties do not act in good faith or where the valuation was unreasonable that the court will be concerned with the problem. Judicial difficulties could be greatly obviated if standards were set up which would, to a great extent, prevent the problem from arising. Under the present Texas procedure for incorporating, the Secretary of State is required to approve all valuations made by the directors before the charter will be issued.⁴⁴ This involves simply a review of the valuations already made by other parties. To carry this method one step further, the Secretary of State might be required to make the initial valuations. This could be done by requiring any corporation contemplating an exchange of stock for property to notify the Secretary of State of that fact and also to describe the property and give its location. Unbiased appraisers, experts in their field and employees of the Secretary of State, could then make an actual appraisal of the property and arrive at the value. Notice would then be sent to the corporation that stock could be issued in exchange for the particular property in question to an amount not in excess of the value found by the appraisers. The actual valuation would then be taken out of the hands of the corporation and placed within the duties of the Secretary of State, or possibly of the Securities Commissioner. Thus it would be possible to avoid over-valuation resulting from excessive enthusiasm on the part of directors or promoters, as well as intentional over-valuations, both of which result in "watered" stock. While it might be argued that such a power to regulate would be excessive, yet abuses thereof could be guarded against by a provision for an appeal from the valuation as set by the office of the Secretary

⁴⁴ TEX. REV. CIV. STAT. (Vernon, 1925) ANN. art. 1308.

of State to the courts in those cases where fraud is alleged on the part of the appraisers, or where it is alleged that the appraisers departed materially from a scientific method of appraisal. A similar system to the one suggested above has been embodied in the general incorporation statutes of Iowa which provide for an executive council.⁴⁵ Some regulation, more stringent than any imposed by existing statutes, seems desirable for the protection of those investors and creditors who rely on the appearance of the corporate condition.

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⁴⁵ IOWA CODE (1946) c. 492, § 492.7.