Valuation of Property Paid for Stock: A Reappraisal

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The obligations of corporate shareholders extend in two directions: to the corporation on the one hand, and to creditors of the corporation on the other.

To the corporation the shareholders are bound to pay the full value of their shares, either in money or money’s worth. When the shareholder has once paid into the corporate treasury the full value of his shares, his liability, for all practical purposes, ceases. Unless the articles of association to which he has agreed provide for special levies or assessments the corporation has no further claim upon him. Nor may the state order a levy upon the shareholders for the benefit of creditors or others unless it has reserved the right to amend the corporate charter, or unless the statutory law, which is a part of the charter, expressly provides for such assessment.\(^1\) Further, even if a majority of the shareholders should, by means of a by-law, order an assessment upon all the shareholders, the corporation would be powerless to compel an unwilling shareholder to contribute.

To the creditors of the corporation shareholders are bound (a) for unpaid stock subscriptions; (b) for watered or fictitiously paid up stock.

With respect to both corporate and creditor obligations of the shareholder it is apparent that the question of paramount importance is whether or not the shareholder has actually paid the full value of his shares. If he has done so, neither the corporation nor its creditors have any valid basis for complaint. What he and the other shareholders paid in constitutes the permanent capital of the corporation. It is there for all to see. But the other shareholders and the creditors may rely on the fact that the shareholder has paid in full for his shares. If he has not done so, protection of the remaining shareholders and creditors is unjustly diminished; the non-paying shareholder will be liable to the extent that his shares have not been fully paid for.\(^2\) It is the purpose

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1. See Dremen v. Mercantile Trust & Deposit Co., 115 Ala. 592, 23 So. 164 (1897); Cullen v. Abbott, 201 Wis. 255, 229 N. W. 85 (1930).

2. Although it is not within the scope of this article to enter into any discussion of the various theories upon which the non-paying shareholder is held liable, it should be noted that the corporation has a remedy only when the shareholder has not fully paid what he agreed to pay, in which case a creditor-debtor relationship exists between the corporation and the non-paying shareholder; the debt represents a corporate asset. If, however, the shareholder has paid all that he agreed to pay, and his shares are issued as fully paid, the corporation has no redress against him even though his shares are not fully paid in fact. But binding as this agreement is between the corporation and the shareholder, it in no way affects the rights of a creditor. Four principal theories have been advanced by the courts in allowing creditors to recover: fraud (creditor relied on paid-in capital of corporation as represented); trust fund (unpaid share amounts constitute a trust fund for creditors); joint debtor (shareholders are liable as joint debtors
of this article to examine and reappraise the bases of valuation of property given by the shareholder in exchange for his stock. Put another way, what are the tests and criteria used by the courts in determining whether or not full value has been paid for shares? Are these tests adequate and in line with modern business trends?

II

Money

The judicial tests for the valuation of property paid for stock involve a determination of the fair value and the (statutory) type of consideration.

It is obvious at the very outset that if the shareholder pays for his shares in money no problem of valuation arises except that of simple arithmetical computation; either he has paid in dollars the full value of the shares or he has not. Indeed, some early American statutes expressly provided for share payment in money; and courts, in construing those statutes, held inadequate the payment to the corporation of any other consideration, even though that other consideration was the equivalent of the full money value of the shares.\(^3\)

Gradually, however, it became apparent that such requirements were impractical.\(^4\) Today nearly every jurisdiction has express statutory provisions permitting the issuance of stock for consideration other than money.\(^5\) Immediate dangers were apparent, however, in the form of stock watering, for as soon as considerations other than money were permitted there arose the ever-present chance that the other considerations might be overvalued and not representative of the full share value. It is only natural, then, that these other-than-money statutes have been tempered with caution.

III

Labor Done

New York Stock Corporation Law § 69 is typical of the majority of state statutes in providing that, "No corporation shall issue either shares of

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4. "Corporations must own property for the purposes of their legitimate business, and it would be a useless formality to receive money in payment for the stock and return it again in payment for the property." Garrett v. Kansas City Coal Mining Co., 113 Mo. 330, 20 S. W. 965 (1892).

5. For a collection of constitutional and statutory provisions see 4 Fletcher, Cyc. of Corps. §§ 5209-5214.
stock or bonds, except for money, labor done or property actually received for the use and lawful purposes of such corporation. . .” Judicial controversies involving this common type of statute have, in large part, been concerned with the valuation of promotional services. Before the court can proceed to any actual valuation, however, the question must first be answered, What constitutes “money, labor done or property actually received”? Would services performed in organizing the corporate enterprise amount to “labor done” or “property actually received”? Most courts were quick to answer in the negative. In an early leading case the New York court said: “The statute requires that stock shall be paid for either by cash or property. Services rendered in bringing a corporation into existence is neither cash nor property. If it were, then the entire capital stock could thus be disposed of, and the only asset which the corporation would have would be its naked existence.” And in Ludlam v. Riverhead Bond & Mortgage Corp., another New York court, thirty-five years later, repeated, “Neither the stock nor the property of a corporation may be issued or paid out to a promoter for his services in organizing the corporation.”

Suppose, however, that the promoter is allotted shares not for bringing the corporation into existence but for remaining with the enterprise after it has reached the going concern stage. The court was faced with such a problem in Wellington Bull & Co., Inc., v. Morris. The corporation in that case was formed pursuant to Morris’ idea to organize Morris Plan banks. The defendant, Morris, was essential to the continued life of the enterprise, at least both in the unanimous opinion of the directors, who approved the stock allotment under attack, and in the unanimous ratification of the allotment plan by the stockholders. In holding for the defendant the court failed to discuss the “money, labor done or property actually received” requirement of the statute, basing its decision instead upon lack of bad faith, clear oppression or breach of trust by the directors coupled with unanimous proxy ratification by the shareholders, of whom the plaintiff was one. In the Morris case, then, there was an independent board of directors and full disclosure of all the facts to the shareholders. But important as those factors are, should a defendant in a Morris-type situation be allowed to retain his added share compensation in the face of statutes such as New York Stock Corporation

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6. Even if the state statute does not contain the exact wording of the New York statute (“money, labor done or property actually received”) judicial decision has required payment to be in those forms prior to reaching the actual process of evaluating what was given by the shareholder in exchange for his shares.


Law § 69? It is no answer to say that the shareholders “ratified” the stock allotment plan if it is otherwise violative of the statute, for an illegal act cannot be ratified. Nor had Morris given any money or property or done any labor in the usual sense of those terms. Indeed, the court pointed out that, “Nor can it be said that the extra compensation was for past services.” (Italics added) It cannot be forgotten, however, that Morris was part and parcel of the enterprise. With his continued services the venture might succeed; without him the plan was practically assured of failure. Could it not be argued in a common sense vein, then, that the agreement under which the directors induced Morris to remain with the organization amounted to “property actually received”? The conclusion seems inescapable that Morris’ continued services were as much, if not more, of an asset to the corporation than physical equipment such as a plant or machinery. It is submitted that the courts do not wish to strike down such an arrangement merely because the requirements of the “money, labor done or property actually received” portions of the statute are not technically fulfilled. The danger in non-fulfillment lies in overvaluation and consequent harm to shareholders and creditors, not in honest evaluation of an asset.11

IV

Property Actually Received

Faced with the statutory requirements of “money, labor done or property actually received” (or statutory words of similar import), and having been able to contribute neither of the first two, the promoter, incorporator, or other person connected with the organization who receives compensation in the form of stock, may turn to the third of these alternatives, “property actually received.” If the property donated by him is tangible in character, the further problem of whether its value is equal to the value of the shares received by him remains. Similarly, only the problem of valuation remains if the donated property is intangible, as in the Morris case.12 This problem of actual valuation will be discussed presently. Again, however, before the computation of value stage is reached the courts may often be called upon to decide whether a particular donation is property, just as they are called upon to decide what is and what is not “labor done.”

A common method of attempted compliance with the “property actually received” requirement of the statute is that of payment by promissory note.

11. As has been previously indicated, when the statute requires “labor done,” labor to be done would not be a proper basis on which to allot additional share compensation. The case of Morgan v. Bon Bon, 222 N. Y. 22, 118 N. E. 205 (1917), however, suggests a method of compensation not violative of the statute: framing the contract to stipulate that the labor to be done (services to be performed) shall be paid for when performed.

12. See note 10 supra.
Is the donation of a promissory note either "money" or "property actually received"?

First, it is clear that unless the statute or charter expressly prohibits the taking of promissory notes as payment for stock the corporation may do so. Whether the delivery of the note constitutes payment, however, is another matter. It has been successfully argued in several jurisdictions that a promissory note is no more than a promise to pay and that payment of the note, not its delivery to the corporation, constitutes payment for shares. The seeming weight of this argument disappears somewhat when the note is secured, for, in effect, the corporation, on delivery of the note itself, now has an investment of definite worth.

The giving of a check has been uniformly regarded as the equivalent of either "money" or "property actually received." 

V

The Valuation Process

Assuming that the foregoing statutory requirements have been fulfilled, that is, that what was given by the person who received the stock constituted either "money, labor done or property actually received," the problem remains of determining whether what was given in exchange for the stock was equivalent in value to the shares received.

There now is raised the all-important question of what method the courts should use in solving the problem of fair valuation. Examination of judicial pronouncements on the subject reveals that two different tests have been employed: the "true value" rule and the "good faith" rule.

(a) true value rule

If the court uses the true value rule in arriving at a determination of whether what was given in a medium other than money as payment for the shares, theoretically nothing but the actual value in fact is taken into account. Suppose, for example, that a new refrigerator, just out of the showroom, was given in exchange for shares. Suppose further that the retail price of this refrigerator was $400, not just in one store but all over the country. The

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14. For an exhaustive collection of authorities see 11 Fletcher, Cyclopedia of Corp. §§ 5194-5195.
15. See The Southern Life Insurance & Trust Co. v. Lanier, 5 Fla. 110, 58 Am. Dec. 448 (1853); Pacific Trust Co. v. Dorsey, 72 Cal. 55, 12 Pac. 49 (1886).
16. Furlong v. Johnston, 209 App. Div. 198, 204 N. Y. Supp. 710 (1924). But if the check is given with intent to defraud, no such rule obtains. Furlong v. Johnston, supra. It should also be noted here that courts allow issuance of stock in exchange for patents, trademarks, and stock of other corporations (where the issuing corporation has such power). See 11 Fletcher, Cyclopedia of Corp. §§ 5189-5192.
“true value” of that refrigerator would be placed at $400. But suppose that the directors who issued the shares honestly believed it to be worth $450 and exchanged shares on that basis; assume that they were acting in the utmost good faith but made an honest error. Under the true value rule the shareholder would be liable to creditors in an assessment action for $50.

Such a result might seem perfectly fair, and such indeed might be the case if the thing given in exchange for stock were always so easily evaluated. All that the plaintiff would have to show would be the true value “in fact” of the thing given; no other elements would enter the situation. But the fallacy in such a proposition lies in the fact that the hypothetical refrigerator case just posed is the exception, not the rule. Suppose again that what is given in exchange for shares is jewelry. Suppose further that the directors, again acting with the highest degree of good faith, put a value of $1000 on the jewelry. If the court should later decide that the true value in fact of the jewelry was $800, the shareholder would be liable for the difference. In the jewelry case, and even in the refrigerator case, the matter of value was not one of fact but of opinion. True, the refrigerator had a price tag of $400 placed on it. But in the last analysis this price represented only the collective buyers’ opinion of its worth. Although it would be difficult to see how opinions could differ as to the price of the refrigerator if an investigation had been made, it is equally difficult to see how they might not differ in the usual case.17 It is submitted that the words “true value” are misleading. What is true value to you may be false value to me. More than that, the shareholder can seldom be secure in the knowledge that he has fully paid for his shares whenever his payment is in a medium other than money. His innocence, the innocence and good faith of the directors, or even of those persons who were employed by the directors as appraisers of his property—all these factors mean nothing, for the valuation is constantly open to judicial scrutiny and possible upset with resulting penalty to the shareholder.

It seems appropriate to ask at this point what good purpose is served by subscribing to the true value rule. Does not the rule, starting from the false premise that value is a matter of fact and not opinion, place an artificial premium on prevention of overvaluation of property and at too much of a risk to the shareholder, especially when adequate protection can be achieved through other equally effective and more realistic tests? Certain it is that legislatures enacted corporation statutes for the avowed purpose of encouraging the formation of corporate enterprises. But it is difficult to see how strict application of the true value rule would in any way promote this purpose; rather it would appear to defeat it.

The chief difference between the true value rule and the good faith rule is that the latter recognizes that value is a matter of opinion, not fact. If the property in question is valued in good faith, the shareholder is relieved from liability, even though the actual value of the property is shown to be less than that placed upon it by the appraisers.\(^1^8\)

There is a division of authority among courts adopting the good faith rule as to what constitutes lack of good faith. It is clear everywhere that honest mistakes of judgment do not spell lack of good faith,\(^1^9\) even where the property was in fact greatly overvalued.\(^2^0\) A conflict of authority exists, however, on whether actual fraud is necessary for a showing of bad faith,\(^2^1\) or whether intentional overvaluation is sufficient. Put another way, in the absence of actual fraud, is the judgment of the directors as to the value of the property conclusive? Or will the courts go behind the transaction if apparent bad faith though not "actual fraud" exists? In insisting on the presence of "actual fraud" before the transaction can be inspected, it is submitted that courts are taking an unrealistic view of the matter. Either the term "actual fraud" should be looked upon as including wilful overvaluation in bad faith or the judgment of the directors should be deemed conclusive only when the plaintiff fails to show bad faith on their part. In short, either the directors have conscientiously attempted to value the property and have used ordinary business judgment in arriving at the valuation or they have not. If they have, then the court should hold in their favor; if they have not, judgment should be to the contrary.\(^2^2\)

\(^1^8\) Typical statutes provide that, "... any corporation may purchase any property authorized by its certificate of incorporation, and may issue stock to the amount of the value in payment therefor ..., and in the absence of fraud in the transaction the judgment of the directors shall be conclusive. ..." See N. Y. STOCK CORP. LAW § 69; FLA. COMP. GEN. LAWS § 6537 (1927).


21. For a collection of cases holding that there must be actual fraud see 11 FLETCHER, CYC. OF CORPS. § 5214.

22. In an excellent book by Dodd, STOCK WATERING, THE JUDICIAL VALUATION OF PROPERTY FOR STOCK ISSUE PURPOSES (1930), the author would ignore the distinction between the true value and good faith rules and would base his conclusion instead on whether the directors exercised ordinary business judgment in their appraisal. The conclusion (drawn) ... from ... (the) review of the several 'good faith' rules as opposed to one another and to the 'true value' rule is that the distinctions are largely verbal. ... There is little or no ground for making a practical distinction between the operation of the several rules, because the question in any case resolves itself into a query as to what was a reasonable valuation of the property as made by the directors in the exercise of ordinary business judgment. ... In effect, the standard of conduct for which all of the courts hold directors and shareholders responsible is that of ordinary business prudence. ..." DONO, supra 92-93.
One of the most difficult problems entering the process of valuation concerns the propriety of considering future earnings or profits as elements of value of the property turned over to the corporation in exchange for stock. Suppose that the X street car company wants to purchase the Y street car company, operating exclusive lines in adjacent territory. The agreement contemplates exchange of X company stock for the Y company franchise and physical equipment. Now, what elements should enter into the valuation of the property being turned over to the X company? Should the court consider the reproduction cost of the Y company property alone, or should future earnings (prospective profits) of the Y company property also be considered as an element of value?

A leading New Jersey case adopted the view that the property exchanged for stock should have a definitely ascertainable value, not merely a speculative value. Accordingly the court held that property should be capitalized at its reproduction value, that future earning power was not a proper element to consider in valuation. Under a governing statute providing that, “The directors of any company incorporated under this act may purchase mines, manufactories or other property necessary for their business,” the court emphasized that the word “property” referred only to “something visible and tangible.”

In the New Jersey case just referred to, however, the enterprise was a new one, with no record of past earnings. In fact, an examination of the decisions holding that contemplated profits are not properly an element of value reveals that the enterprise (property) in question was new and speculative. It is the writer’s belief that in determining whether prospective profits are proper elements of value, the courts actually look to past earnings of the enterprise and then base their decision on what future earnings, if any, would probably develop. It is much less difficult to predict future profits on the basis of the earnings picture of the property in past years than to predict when the enterprise is new and totally lacking in any earning experience.

It is submitted, however, that even where the property has a past earn-

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24. This N. J. statute was subsequently amended to read: “no stock shall be issued for profits not yet earned, but only anticipated.” See Bryson v. Conlen, 104 N. J. Eq. 180, 144 Atl. 723 (1929).
26. See cases cited note 25 supra.
27. But see Gamble v. Queens County Water Co., 123 N. Y. 91, 25 N. E. 201 (1890), where the New York court recognized the valuation of future earnings, taking into consideration the prevention of competition and the saving of business losses.
ings record, predictions as to future profits constitute little more than a guessing game. Conditions, financial or otherwise, may, and often do, change suddenly. At best, future earning power is an uncertain element to take into consideration when evaluating the property to be exchanged for stock.

**Conclusion**

Nearly all statutory requirements with regard to that which is given in exchange for stock issued by the corporation are lacking in creditor and investor protection in that they fail to define adequately “money, labor done or property actually received.” This lack of adequate definition has forced the courts to give strained, and often unavoidably unjust, interpretations when faced with concrete problems of exchange. But courts in general have approached these problems with a realistic attitude. The continued services of a promoter may be of greater value to the enterprise than a building or machinery; a promissory note may well be the equivalent of cash. This practical judicial approach, however, is not because of statutory draftsmanship but in spite of it. Revision on a national scale is in order.

The current “true value” and “good faith” rules are inadequate, both in approach and application, to the actual valuation process. The true value rule, based on the false assumption that value is a matter of fact rather than opinion, was artificially conceived and is artificially applied. The good faith rule, fairer in application, still fails for want of definition of the term “good faith.” A rule requiring in all cases ordinary business prudence and judgment seems much more suited to modern business practices and trends.

In these troublous times if the free enterprise system as we know it is to flourish as it has in the past, investors and lenders of capital must have assurance of adequate protection. The Securities Act of 1933, requiring full disclosure, was a great step forward in this respect on a national scale, but statutory revision and progressive judicial thinking are still sorely needed at the state level.