Should Rich but Losing Corporations Be Liquidated?

By BENJAMIN GRAHAM

THE unprecedented spectacle confronts us of more than one industrial company in three selling for less than its net current assets, with a large number quoted at less than their unencumbered cash. For this situation we have pointed out, in our previous articles, three possible causes: (a) Ignorance of the facts; (b) Compulsion to sell and inability to buy; (c) Unwillingness to buy from fear that the present liquid assets will be dissipated.

In the preceding articles we discussed the first two causes and their numerous implications. But neither the ignorance nor the financial straits of the public could fully account for the current market levels.

If *gold dollars without any strings attached* could actually be purchased for 50 cents, plenty of publicity and plenty of buying power would quickly be marshalled to take advantage of the bargain. Corporate gold dollars are now available in quantity at 50 cents and less—but they *do* have strings attached. Although they belong to the stockholder, he doesn't control them. He may have to sit back and watch them dwindle and disappear as operating losses take their toll. For that reason the public refuses to accept even the cash holdings of corporations at their face value.

IN fact, the hardheaded reader may well ask impatiently: "Why all this talk about liquidating values, *when companies are not going to liquidate?* As far as the stockholders are concerned, their interest in the corporation's cash account is just as theoretical as their interest in the plant account. *If* the business were wound up, the stockholders would get the cash; *if* the enterprise were profitable, the plants would be worth their book value. *"If* we had some ham, etc., etc."

This criticism has force, but there is an answer to it. The stockholders do not have it in their power to make a business profitable, but they do have it in their power to liquidate it. At bottom it is not a theoretical question at all; the issue is both very practical and very pressing.

It is also a highly controversial one. It includes an undoubted conflict of *judgment* between corporate managements and the stock market, and a probable conflict of *interest* between corporate managements and their stockholders.

IN its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?

Which Is Right—the Stock Market or Corporation Management?

ANOTHER aspect of the current maladjustment between corporations and their stockholders is the question of possible liquidation. Many stocks sell for less than their cash value because the market judges that future operating losses will dissipate this cash.

If that is the case, then should not the stockholder demand liquidation before his cash is used up? The management says "No,"—naturally. But the stock market says "Yes,"—emphatically. Which is right? What are the salient factors on both sides of the question?

Forbes presents herewith the third, and last, article in this series by Mr. Graham, which reaches down to the very roots of the present troublous situation.

To-day stockholders are leaving the answer to this problem, as to all other corporate problems, in the hands of their management. But when the latter's judgment is violently challenged by the verdict of the open market, it seems childish to let the management decide whether itself or the market is right. This is especially true when the issue involves a strong conflict of interest between the officials who draw salaries from the business and the owners whose capital is at stake. If you owned a grocery store that was doing badly, you wouldn't leave it to the paid manager to decide whether to keep it going or to shut up shop.

The innate helplessness of the public in the face of this critical problem is aggravated by its acceptance of two pernicious doctrines in the field of corporate administration. The first is that directors have no responsibility for, or interest in, the market price of their securities. The second is that outside stockholders know nothing about the business, and hence their views deserve no consideration unless sponsored by the management.

By virtue of dictum number one, directors succeed in evading all issues based upon the market price of their stock. Principle number two is invoked to excellent advantage in order to squelch any stockholder (not in control) who has the temerity to suggest that those in charge may not be proceeding wisely or in the best interests of their employers. The two together afford managements perfect protection against the necessity of justifying to their stockholders the continuance of the business when the weight of sound opinion points to better results for the owners through liquidation.

THE accepted notion that directors have no concern with the market price of their stock is as fallacious as it is hypocritical. Needless to say, managements are not responsible for market fluctuations, but they should take cognizance of excessively high or unduly low price levels for the shares. They have a duty to protect their stockholders against avoidable depreciation in market value—as far as is reasonably in their power—equal to the duty to protect them against avoidable losses of earnings or assets.

If this duty were admitted and insisted upon, the present absurd relationship between quoted prices and liquidating values would never have come into existence. Directors and stockholders both would recognize that the true value of their stock should under no circumstances be less than the realizable value of the business, which amount in turn would ordinarily be not less than the net quick assets.

They would recognize further that *if the business is not worth its realizable value as a going concern it should be wound up.* Finally, direc-

tors would acknowledge their responsibility to conserve the realizable value of the business against shrinkage and to prevent, as far as is reasonably possible, the establishment of a price level continuously and substantially below the realizable value.

HENCE, instead of viewing with philosophic indifference the collapse of their stock to abysmally low levels, directors would take these declines as a challenge to constructive action. In the first place, they would make every effort to maintain a dividend at least commensurate with the minimum real value of the stock. For this purpose they would draw freely on accumulated surplus, provided the company's financial position remained unimpaired. Secondly, they would not hesitate to direct the stockholders' attention to the existence of minimum liquidating values in excess of the market price, and to assert their confidence in the reality of these values. In the third place, wherever possible, they would aid the stockholders by returning to them surplus cash capital through retirement of shares pro rata at a fair price, as advocated in our previous article.

Finally, they would study carefully the company's situation and outlook, to make sure that the realizable value of the shares is not likely to suffer a substantial shrinkage. If they find there is danger of serious future loss, they would give earnest and fair-minded consideration to the question whether the stockholders' interests might not best be served by sale or liquidation.

HOWEVER forcibly the stock market may be asserting the desirability of liquidation, there are no signs that managements are giving serious consideration to the issue. In fact, the infrequency of voluntary dissolution by companies with diversified ownership may well be a subject of wonder, or of cynicism. In the case of privately owned enterprises, withdrawing from business is an everyday occurrence. But with companies whose stock is widely held, it is the rarest of corporate developments.

Liquidation *after* insolvency is, of course, more frequent, but the idea of shutting up shop *before* the sheriff steps in seems repugnant to the canons of Wall Street. One thing can be said for our corporate managements—they are not quitters. Like Josh Billings, who in patriotic zeal stood ready to sacrifice all his wife's relations on the altar of his country, officials are willing to sacrifice their stockholders' last dollar to keep the business going.

But is it not true that the paid officials are subject to the decisions of the board of directors, who represent the stockholders, and whose duty it is to champion the owners' interests—if necessary, against the interests of the operating management? In theory this cannot be gainsaid, but it doesn't work out in practice.

THE reasons will appear from a study of any typical directorate. Here we find: (a) The paid officials themselves, who are interested in their jobs first and the stockholders second; (b) Investment bankers, whose first interest is in underwriting profits; (c) Commercial bankers, whose first interest is in making and protecting loans; (d) Individuals who do business of various kinds with the company; and finally—and almost always in a scant minority—(e) Directors who are interested only in the welfare of the stockholders.

Even the latter are usually bound by ties of friendship to the officers (that is how they came to be nominated), so that the whole atmosphere of a board meeting is not conducive to any assertion of stockholders' rights against the desires of the operating management. Directors are not dishonest, but they are human. The writer, being himself a member of several boards, knows something of this subject from personal experience.

The conclusion stands out that liquidation is peculiarly an issue for the stockholders. Not only must it be decided by their independent judgment and preference, but in most cases the initiative and pressure to effect liquidation must emanate from stockholders not on the board of directors. In this connection we believe that the recognition of the following principle would be exceedingly helpful:

The fact that a company's shares sell persistently below their liquidating value should fairly raise the question whether liquidation is advisable.

PLEASE note we do not suggest that the low price proves the desirability of liquidation. It merely justifies any stockholder in raising the issue, and entitles his views to respectful attention.

It means that stockholders should consider the issue with an open mind, and decide it on the basis of the facts presented and in accordance with their best individual judgment. No doubt in many of these cases—perhaps the majority—a fair minded study would show liquidation to be unjustified. The going concern value under normal conditions would be found so large, as compared wi sum realizable in liquidatio to warrant seeing the depr through, despite current ope losses.

However, it is conceivable th der present difficult condition owners of a great many busir might conclude that they would better by winding them up r than continuing them. What v be the significance of such a n ment to the economic situation whole? Would it mean further c tion, further unemployment, fu reduction of purchasing po Would stockholders be harming country while helping themsel Superficially it might seem so, powerful arguments can be adva to the opposite effect.

The operation of unsoundly : ated enterprises may be called a d ment, instead of an advantage, to nation. We suffer not only f over-capacity, but still more from disruptive competition of compa which have no chance to survive, continue to exist none the less, to loss of their stockholders and the settlement of their industry.

Without making any profits themselves, they destroy the pr possibilities of other enterpri: Their removal might permit a bet adjustment of supply to demand, a larger output with consequ lower costs to the stronger com nies which remain. An endeavor now being made to accomplish t result in the cotton goods indust

FROM the standpoint of emplo ment, the demand for the pro uct is not reduced by closing do unprofitable units. Hence, produ tion is transferred elsewhere and e ployment in the aggregate may n be diminished. That great individu hardship would be involved cann be denied, nor should it be minimize but in any case the conditions of en ployment in a fundamentally unsour enterprise must be precarious in tl extreme. Admitting that the en ployees must be given sympathet consideration, it is only just to poi out that our economic principles d not include the destruction of stock holders' capital for the sole purpos of providing employment.

We have not yet found any way t prevent depression from throttlin us in the midst of our superabun dance. But unquestionably there ar ways to relieve the plight of th stockholders who to-day own s much and can realize so little. A fresh viewpoint on these matter might work wonders for the sadl demoralized army of American stock holders.