



Intelligent Investing

Should Rich But Losing Corporations Be Liquidated?

Benjamin Graham 07.01.32, 6:00 AM ET

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 marshaled 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 hardhearted 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 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?

To-day stockholders are leaving the answer to his 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 reasonable 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, directors 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 reasonable 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 stock-holders 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' interest 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 county, 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 a 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 with the sum realizable in liquidation, as to warrant seeing the depression through, despite current operating losses.

However, it is conceivable that under present difficult conditions the owners of a great many businesses might conclude that they would fare better by winding them up rather than continuing them. What would be the significance of such a movement to the economic situation as a whole? Would it mean further deflation, further unemployment, further reduction of purchasing power? Would stockholders be harming the country while helping themselves? Superficially it might seem so, but powerful arguments can be advanced to the opposite effect.

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

Without making any profits for themselves, they destroy the profit possibilities of other enterprises. Their removal might permit a better adjustment of supply to demand, and a larger output with consequent lower costs to the stronger companies which remain. An endeavor is now being made to accomplish this result in the cotton goods industry.

From the standpoint of employment, the demand for the product is not reduced by closing down unprofitable units. Hence, production is transferred elsewhere and employment in the aggregate may not be diminished. That great individual hardship would be involved cannot be denied, nor should it be minimized, but in any case the conditions for employment in a fundamentally unsound enterprise must be precarious in the extreme. Admitting that the employees must be given sympathetic consideration, it is only just to point out that our economic principles do not include the destruction of stockholders' capital for the sole purpose of providing employment.

We have not yet found any way to prevent depression from throttling us in the midst of our superabundance. But unquestioningly there are ways to relieve the plight of the stockholders who to-day own so much and can realize so little. A fresh viewpoint on these matters might work wonders for the sadly demoralized army of American stockholders.

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. Which Is Right--the Stock Market or Corporation Management?

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 troubrous situation.