Opinion No. 17-2041

August 6, 1917

BY: GEORGE C. TAYLOR, Assistant Attorney General

TO: Hon. A. G. Whittier, State Traveling Auditor, Santa Fe, New Mexico.

The Determination of the Value of a Franchise.

OPINION

This is in reply to your letter of June 6th, 1917, in which you ask certain questions as to how the value of a franchise may be determined, what is a franchise; how the value of the plant of a public utility corporation be fixed and when is a corporation insolvent.

It would be impossible, within the limits of this letter, to do more than suggest the barest outlines on these questions, about which dozens of books have been written and hundreds of decisions handed down, and as to which there exist many conflicting theories.

It has been variously held by the courts of different states that the proper method of valuing a public utility is to capitalize their net earnings upon a reasonably fair rate; that they should be valued at their original cost, less depreciation; upon the cost of reproducing at the present time, less depreciation, and upon the basis of outstanding capitalization; by the market value of its securities, and, finally, by a valuation based upon all of these elements. The method to be followed is likewise determined, to a considerable extent, by the purpose for which the property is being valued, that is, whether for taxation, condemnation or purchase by a municipality, to ascertain what constitutes an equitable charge or rate, and, finally, by statute, in many states in accounting, to determine whether or not stock or bond issues shall be permitted (under "Blue Sky" laws). Most of the litigation and discussion of the question has involved the second and third purposes -- rate making and purchase by municipalities.

You first ask for a definition of a franchise. The term, of course, has a number of meanings but I take it that you use it to cover the special privilege or right to construct, maintain and operate in a public highway, and some instrumentality intended for public use, as a street railway. This is termed a special or secondary franchise as distinguished from primary or general franchise, which is the mere right of being a body corporate. A franchise is a "privilege emanating from the sovereign power of the state." "A privilege of authority vested in certain persons, by a grant from the sovereign authority in the state, to exercise powers, or perform acts, which, without such grant, they could not do or perform." Numerous other definitions, generally using the term "privilege" or "grant," may be found in Joyce on Franchise, Sections 1 to 9, inclusive.

In the case of Consolidated Gas Company v. City of New York, 157 Fed. 849, the United States Circuit Court held that the franchise should be included in making a valuation of a public service corporation, and that its reasonable value could be ascertained by deducting the company's actual investment in tangible property, from its total issue of stock, the difference being the value of the franchise. In this case the corporation had issued a large amount of stock in excess of its actual investment, but had been able to pay a reasonable divident on the total stock; presumably if such stock was selling considerably below par, so that its total value would about correspond to the actual investment, it would follow that the franchise had no value. Other cases take the view that the franchise is to be valued at precisely what it cost the corporation to acquire it; where they get it as a gift from a municipality, it has no value, and where the expense is only nominal, as for legal services and the like, the corporation may not claim a higher value than this expenses.

It may be said at this point, that the method of adding capital stock issue to bond issue, in determining public utility valuations, has been entirely discarded everywhere. In Pond on Public Utilities, page 548, it is said:

"Indeed so great has become the discrepancy between capitalization and actual value that there seems to be no logical connection between the two."

He further says that neither the capitalization nor the stock market valuation are proper measures of the actual valuation of the investment. Probably the best test is suggested in the following quotation from Pond, page 549:

"While all accurate available evidence of the original cost, as well as the cost of reproduction is desirable and helpful in determining the extent of the actual investment necessary to render the service in any particular case, neither these nor the amount of capitalization are conclusive. The present market value of the plant or its worth as a going concern is the ultimate practical basis for determining the value of the investment upon which to fix a rate which will produce a fair return. The investment is the actual market value of the property which is being used for the public and is useful or necessary at the time to render the service which, as a going concern, includes the right of being a body corporate as well as the special privilege of using the streets and other public places of the municipality which is necessary for rendering the service; and as these special franchise privileges are necessary to the operation of the municipal public utility, the actual legitimate expense of securing them is a proper element of the investment, although on the other hand, as the courts have observed, where this privilege is given outright by the municipality it is difficult for the municipal public utility to justify its action in placing a high valuation on its franchise for the purpose of determining the amount of the investment upon which the inhabitants of the municipality, who have already given the privilege, should be required to pay at an increased rate for the service which it receives."

The following quotation from page 555 is also instructive:

"PRESENT ACTUAL PHYSICAL VALUATION AS GOING CONCERN. -- The recent case of Des Moines Water Co. v. Des Moines, 192 Fed. 193, decided in 1911, furnishes a practical decision of this point where the court says: 'What is the value of the plant today? There must be a reasonable rate of interest or dividends allowed on the value of the plant. If a concern is not profitable, the investors must lose their money. If the plant is a profitable one, then such profits can not exceed a reasonable rate of interest or dividends. * * * 1. There can be no true test, other than the physical valuation, and to such physical valuation there may be added certain other items.'

"That the true valuation is the actual present value of the investment of the municipal public utility as a going concern is the effect of the decision in the case of Cedar Rapids Gaslight Co. v. Cedar Rapids, 144, Iowa, 426, 120 N. W. 966, 138 Am. St. 299, 223 U.S. 655, 56 L. ed. 596, decided in 1909, for as the court says: 'As said, the value of the system as completed, earning a present income, is the criterion. In so far as influenced by income, however, the computation necessarily must be made on the basis of reasonable charges, for whatever is exacted for a public service in excess of this is to be regarded as unlawful. Save as above indicated, the element of value designated a "going concern" is but another name for "good will," which is not to be taken into account in a case like this, where the company is granted a monopoly. Cedar Rapids Water Company v. City of Cedar Rapids, 118 Iowa 234, 91 N. W. 1081 199 U.S. 600, 50 L. ed 327; Wilcox v. Consolidated Gas Co., 212 U.S. 19, 53 L. ed. 382. * * * in ascertaining values in this way, the worth of a new plant of equal capacity, efficiency, and durability, with proper discounts for defects in the old and depreciation for use, should be the measure of value rather than the cost of exact duplication.'"

The value of the franchise -- even in those cases in which the court holds it is to be included in the valuation, must depend largely on its duration, whether it has a few years or many to run, or may be cancelled by the municipality at its option. As a rule those courts supporting the theory of original cost or cost of reproduction, refuse to regard the franchise as an element of value, unless it has been actually paid for; it may be further said that the later decisions appear to be adopting this view, particularly the decisions of the State Corporation Commission. It seems to the writer that if the company has been earning a fair profit on its total capitalization, that for the purpose of the valuation you are making, the franchise should be given some valuation; but, as I understand from your letter it is only paying expenses, I do not see how the franchise could be given any considerable valuation, unless it is probable that, based on the corporation's present rate basis, they may reasonably anticipate a considerable profit in the future. It would be unfair to the company to disregard this franchise value entirely, even though they are barely meeting expenses at this time, if a future profit may be reasonably anticipated.

The same general considerations are equally applicable to the valuation of the "plant." For the purposes of your valuation, however, it appears to the writer that the preferable basis would be the market value of the company's securities. Provided they have any real market value as distinguished from the price below which organizers or security holders may have agreed not to sell. In other words, if artificially bolstered for

speculative or other reasons, the market value would be an unsafe index. It would seem to be advisable then, to consider the original cost of construction, less a reasonable depreciation along with the present cost of reproduction, and, as prices in general have advanced considerably within the last year or two, the cost of reproduction, less depreciation, would seem to be the safest and most equitable method. You are certainly right in taking exception to the company's method of fixing the valuation of the plant by adding together its actual issued capital stock, together with the bond issue. As already suggested, there is but little connection between the capitalization of the plant and its present reasonable selling value.

As to the fourth section of your letter, an insolvent corporation has been defined to be one whose property is insufficient to satisfy its creditors; also one which is not able to pay its debts, including the amount paid in on the subscription to its stock, Jones on Insolvent and Failing Corporations, pages 10 and 11, and cases cited. However, as this authority says, it is not an easy matter to lay down any fixed and prescribed definition, but the facts and circumstances of such case must be considered, particularly as the term is used in several senses. A person may only be considered insolvent when his means, assets or entire property is insufficient to pay his debts and this depends not upon the nominal value of his property, but upon whether or not enough can be realized therefrom upon sale thereof, to discharge his liabilities. The term is frequently used to denote the inability of a trader or party to pay his obligations as they become due, or mature in the ordinary and usual course of business. But in New Mexico, in view of the decision in Department Store v. Hat Company, 17 N.M. 112, it would seem that there must be a concurrence of these two elements, that is, there must be an excess of liabilities over the assets, as well as an inability to meet current obligations as they mature, either through payment or by the legitimate use of credit. This decision is based on a number of New Mexico cases construing the statute from which the New Mexico statute was taken. In the case of State v. Trinity etc. Society, 127 S. W. 1174, it was held that mere excess of liabilities, particularly immature liabilities, where the corporation was a going concern meeting its current obligations, did not constitute insolvency. This, I believe to be the appropriate rule under the circumstances outlined by you. In other words, so long as a public utility corporation is a going concern fully able to, and in fact meeting all current obligations as they mature, and with a reasonable expectation of continuing to do so, it could not be termed insolvent in the narrow sense as justifying the appointment of a receiver, even though a forced liquidation at this time might show an excess of liabilities over the assets, as stated, insolvency is frequently used in a broader sense to cover this latter condition.

Trusting that the foregoing may be of assistance to you, I am,