

2818.

BUILDING AND LOAN ASSOCIATION—BOOK VALUE OF PROPERTY OBTAINED THROUGH FORECLOSURE—DETERMINATION OF SUCH VALUE DISCUSSED.

SYLLABUS:

1. *When a building and loan association purchases real estate in a foreclosure proceeding for an amount less than theretofore loaned thereon, the transaction should be closed at the time the foreclosure is terminated and such property should be carried on the books of the company at its true value, but not exceeding the cost of same to the company in the foreclosure proceeding, the loss being charged to either the undivided profit fund or to the reserve fund.*
2. *When a loss has been charged to the reserve fund or the undivided profit fund or both as a result of a foreclosure proceeding at which a building and loan association has purchased property for less than the amount loaned thereon, when such property is ultimately sold for an amount greater than it had been carried on the books of the association or when the deficiency judgment is paid, the undivided profit fund, the reserve fund, or both, as the case might be, should be reimbursed up to the extent of the loss theretofore charged off.*
3. *Under the circumstances, if the value of such real estate is more than the cost, it should be carried on the books of the company at the amount bid, which includes court costs and taxes.*
4. *In the event property is purchased at foreclosure proceedings by a building and loan association for an amount in excess of the amount loaned thereon, such excess being a sum to pay court costs and taxes, the real estate should be carried on the books at the amount of the loan, and court costs and taxes should be charged to the undivided profit fund or to the reserve fund.*

COLUMBUS, OHIO, January 12, 1931.

HON. JOHN W. PRUGH, *Superintendent, Building and Loan Associations, Columbus, Ohio.*

DEAR SIR:—Your letter of recent date is as follows:

“Under date of August 15, 1912 an opinion was rendered to this office setting out the procedure necessary to be followed by building and loan associations with respect to the handling of real estate acquired through foreclosure proceedings.

For reasons hereinafter pointed out, we desire to obtain a modification of that opinion so as more equitably to meet the exigencies of the present situation confronting building and loan associations with respect to the acquisition and handling of real estate which they find it necessary to acquire through foreclosure proceedings.

The plan which seems fair to this office is to allow the company to continue to carry real estate upon its books at the amount of the balance due on the loan at the time of foreclosure, uncollected interest, of course, not to be taken into consideration, and to permit court costs and taxes to be charged either out of the earnings as an ordinary expense or out of the reserve fund as a loan.

In view of the fact that the amount of the bid is variable and does not represent a fixed disbursement as do amounts ordinarily paid out by a financial institution, it seems to us that the use of the bid as a basis of determining book value makes possible the creation of assets of an amount not exactly reflecting the amount of money which the company was compelled to invest

in the property through the making of the loan and the subsequent acquiring of title to the property.

The procedure possible by adhering literally to the opinion has been in some cases to permit charging loss from the reserve fund and the obtaining of a like amount of profit when the property is sold. The profit derived from the sale is thus enhanced in the amount of loss so charged off, or in other words, a part of the reserve fund, which under the law is intended to be used only to take care of losses, is converted into profit.

We are inclined to the view that consideration of this matter at the time the opinion was rendered was to some extent at least determined from the fact that real estate taken over by building and loan associations was a very unusual procedure, being one which did not greatly enter into the business. Conditions now, however, are somewhat different, as in the past two years or more the real estate situation in this state has been such as to make it in many cases imperative for the company in order to protect its interests to take over a great many parcels of real estate. While it may be true that the same principle which applies in one instance should apply in all we do feel that under the present conditions danger can be avoided by permitting the company to continue to carry the book value of real estate upon the basis of the amount represented by the balance due on its loan rather than to require the charging off of losses in the manner indicated in the opinion. By so doing the possibility of creating profits in the manner above pointed out would be removed.

For these reasons we again submit this question with the request that you advise whether or not under the situations now confronting these associations the opinion cannot be modified in a way that will not require the adjustment of any loss until such time as the loss becomes a reality when the property is sold by the association.

If you desire to go into this more fully, we shall be glad to present specific transactions, pointing out some of the matters to which reference is made."

The opinion to which you refer rendered by this office in 1912 appears in the Annual Report of the Attorney General for the year 1912, Vol. I, p. 742. The syllabus is as follows:

"The term 'contingent losses', as employed in Section 9671 of the General Code, requiring building and loan associations to pay all such out of a reserve fund created for that purpose, must be distinguished from the term 'expenses', which, in accordance with Sections 9672 and 9673 of the General Code, are required to be paid out of the earnings.

Ordinarily, when an investigation (investment) is being carried upon the books of the company at a profit, the costs of foreclosure, such as taxes, court costs, attorneys' fees, etc., should be charged as expenses and paid out of the earnings.

In a foreclosure proceeding, however, when property mortgaged to the company, is sold at a loss, the term 'losses' means 'the difference between the amount invested by the loan association in a given case and the amount received back by the company when the investment is terminated.' In such a foreclosure, therefore, the difference between the amount loaned and the amount received for the property, after the costs and taxes are paid out of the proceeds of sale, must be charged to the reserve fund authorized under Section 9659 of the General Code for the payment of 'contingent losses.'

Attorneys' fees in such proceedings not being paid out of the proceeds,

and being entirely under the control of the company, should be paid as expenses out of the earnings of the company."

In the opinion, the then Attorney General cited as an illustration a situation wherein a building and loan association has \$2000 loaned upon a tract of real estate, said loan being secured by a mortgage. Upon foreclosure of the mortgage, the real estate is sold for an amount that, after deducting costs and taxes, there is \$1200 remaining from the purchase price to be paid to the association. After discussing this illustration in explanation of how costs and taxes should be handled as distinguished from attorneys' fees, the then Attorney General used the following language on p. 745:

"Referring again to the case I have stated suppose the property instead of being bought in by a third person is bought in by the company, it seems to me that the procedure would be the same. From the amount bid by the company for the property should be deducted the amount of taxes and costs which it would have to pay before receiving a deed, and the remainder should be subtracted from the amount due the company on its mortgage, and this difference should be immediately charged to the 'reserve fund', and the real estate then carried on the books of the company at the amount bid for the same less said costs and taxes.

The transaction should be closed at the time the foreclosure is terminated and whatever loss has been incurred by the company should be charged to the 'reserve fund' at that time, and the property thereafter carried on the books of the company at the cost of the same to the company in the foreclosure case."

Using the same illustration, it is evident that if at the time of foreclosure the property is actually worth \$2000 and is in fact subsequently sold for \$2000, the procedure recommended in the opinion of 1912 results in the enhancement of the profit account at the expense of the reserve account. There are conceivably many instances when property is purchased by a building and loan association at a forced sale for an amount materially less than its actual value. In the event such property, which is purchased by a building and loan association at a price less than the amount loaned on the property, is carried on the books at the amount of the loan rather than at the cost price, the profit account would not be enhanced at the expense of the reserve fund after sale for an amount in excess of the purchase price. The adoption of such a method of accounting would, however, in my opinion, have a tendency to adversely affect the stability of building and loan associations; this, for the reason that there would be a tendency to increase loans by raising appraisements in the first instance. In the event such mortgage is foreclosed, the property could be purchased by the building and loan association and notwithstanding the fact that it may have been purchased at its true value which may be far less than the amount loaned on the property, the statement of such building and loan association, carrying the property at the amount of the loan, would not reflect the true financial condition until such time in the future as the property is finally sold, or until such time as the superintendent of building and loan associations might discover the fact that property is being carried on the books at a value in excess of its true worth. This method would result in placing a responsibility and burden upon your department such as was manifestly not contemplated by the legislature.

It appears to me that the entire difficulty arises on account of the fact that building and loan associations have heretofore charged losses first to the reserve fund, irrespective of whether or not such associations may have an undivided profit fund. In my opinion, the sound accounting practice is that followed by the banks. When a bank forecloses a mortgage and purchases the property, the transaction is closed at

the time the foreclosure is terminated, and in the event the property is purchased at less than the amount of the loan, the loss, instead of being charged to the surplus account (which account in the case of a bank corresponds with the reserve fund in the case of a building and loan association), is charged to the profit account. The property is carried in the statement as "other real estate" at the price at which it is purchased. This practice enables the financial institution to reflect its true condition in its statement, and the situation with which you are confronted is avoided because the profit account is not ultimately inflated at the expense of the surplus.

The sections of the law relating to building and loan associations do not contain any mandatory provision that losses must be charged in the first instance to the reserve fund, nor do I find any provision which would preclude charging losses in the first instance to the undivided profit fund until such fund had become exhausted and then to the reserve fund.

Section 9659, General Code, being one of the sections defining the powers of building and loan associations, provides:

"To accumulate from the earnings a 'reserve fund' for the payment of contingent losses, and an 'undivided profit fund', both of which may be loaned and invested as other funds of the association."

Section 9671, General Code, is as follows:

"The amount to be set aside to the reserve fund, for the payment of contingent losses shall be determined by the board of directors, but in all permanent or perpetual associations, at least five per cent of the net earnings shall be set aside each year to such fund until it reaches at least five per cent of the total assets. All losses shall be paid out of such fund until it is exhausted. When the amount in such fund falls below five per cent of the assets as aforesaid, it shall be replenished by annual appropriations of at least five per cent of the net earnings as hereinbefore provided until it again reaches such amount."

It does not necessarily follow that because all losses must be paid out of the reserve fund until it is exhausted, such losses must be charged to this fund in the first instance, in the event a building and loan association has an undivided profit fund. The practice of charging losses first to the reserve fund until it is exhausted and then after having exhausted the reserve fund, to charge losses to the undivided profit fund, results in the undivided profit fund, while perhaps not so called, becoming in fact the reserve fund. This practice further results in building and loan associations using the fund which serves the purpose of a reserve, although called an undivided profit fund, for the payment of dividends.

Section 9673, General Code, provides as follows:

"After payment of expenses and interest, a portion of the earnings to be determined by the board of directors, annually or semi-annually, shall also be placed in the reserve fund for the payment of contingent losses, as hereinbefore provided, and a further portion of such earnings to be determined by the board of directors, shall be transferred as a dividend annually or semi-annually, in such proportion to the credit of all members as the corporation by its constitution and by-laws provides, to be paid to them at such time and in such manner in conformity with this chapter as the corporation by its constitution and by-laws provides. Any residue of such earnings may be held as undivided profits to be used as other earnings, except that such undivided

profit fund at no time shall exceed three per cent of the total assets of the association."

The mandatory provision therein contained that a portion of the earnings shall be placed in the reserve fund before any portion shall be paid as dividends does not carry any implication that the reserve fund shall be used to take care of losses ahead of the undivided profit fund. The establishment of an undivided profit fund is apparently not mandatory.

Section 9674, General Code, provides:

"All losses shall be assessed in the same proportion and manner on all members after the amounts in the reserve fund and the undivided profit fund have been applied to the payment thereof."

It is perhaps because the reference herein to the reserve fund precedes the reference to the undivided profit fund that the practice has grown up of charging losses first to the reserve fund notwithstanding the fact that an undivided profit fund may have been established. In the absence of an express provision on this point, it is, I believe, reasonable to assume that the legislature contemplated following sound and established accounting practice. It should be observed that there is, of course, no mandatory requirement that losses should be charged first to the undivided profit fund.

Summarizing, it is evident that under the present method of accounting as set forth in the opinion of 1912, when considerable property is purchased in foreclosure proceedings by a building and loan association for less than its true value and less than the amount loaned on such property, the reserve fund is depleted and the profit fund improperly enhanced when such property is sold at a price greater than the purchase price; it is also evident that if under such circumstances this property is carried in all instances at the amount of the loan, the statements of building and loan associations might not reflect their true condition.

I have indicated that when property is purchased at foreclosure proceedings at less than the amount previously loaned thereon, it should be carried on the books at cost or value, whichever is less. The accounting practice of carrying assets at "cost or value, whichever less" seems to be well established. As to just what is cost under such circumstances, I am unable to concur in the 1912 opinion. This opinion held, as hereinabove set forth, that where the amount of a loan on a property is \$2000 and the company at the foreclosure proceedings bids \$1500, the court costs and taxes, amounting to \$300, should be deducted from the \$1500 bid, and the real estate carried on the books of the company at \$1200, being the amount bid less costs and taxes. Under such circumstances, there is no question but that \$800 must be charged to either the undivided profit fund or the reserve fund. The cost of the property to the company, however, is in my opinion \$1500 and the property should be carried on the books at such figure. This will not affect the conclusion that \$800 must be charged to the undivided profit or reserve fund for the reason that there will be two charges against such fund, one of \$500, being the difference between the amount at which the property is to be carried on the books and the amount loaned, and one of \$300, being the debit against the undivided profit or reserve fund to balance the credit entry of \$300 cash which the company would have to pay for a deed.

In the event the company were to buy in this property at the maximum price to protect the loan, the company would purchase the property at \$2300, \$2000 being the amount loaned and \$300, being court costs and taxes. The rule of "cost or value, whichever less" would then be applied. In this case, the value is the loan value or the

mortgage figure of \$2000. The real estate would then be carried on the books at \$2000 and the undivided profit or reserve fund would be debited \$300 to balance the cash credit.

Coming back to the situation arising when a building and loan association so purchases property at less than the amount loaned thereon, it must be borne in mind that the loss is somewhat in the nature of a contingent loss—the contingency being subject to final determination upon the ultimate sale of the property and also subject to final determination in the event execution is had upon a deficiency judgment. In my view, sound accounting practice would require that upon such ultimate sale, if the property is sold for an amount more than it had been theretofore carried on the books, the undivided profit fund, or the reserve fund or both, as the case might be, should be reimbursed to the extent of loss theretofore charged to such fund or funds as a result of the foreclosure. There is nothing in the law to preclude such practice. There should certainly be no profit set up until the fund or funds have been first reimbursed to the extent of the loss theretofore charged off on a particular transaction.

In view of the foregoing, it is my opinion that:

1. When a building and loan association purchases real estate in a foreclosure proceeding for an amount less than theretofore loaned thereon, the transaction should be closed at the time the foreclosure is terminated and such property should be carried on the books of the company at its true value, but not exceeding the cost of same to the company in the foreclosure proceeding, the loss being charged to either the undivided profit fund or to the reserve fund.

2. When a loss has been charged to the reserve fund or the undivided profit fund or both as a result of a foreclosure proceeding at which a building and loan association has purchased property for less than the amount loaned thereon, when such property is ultimately sold for an amount greater than it had been carried on the books of the association or when the deficiency judgment is paid, the undivided profit fund, the reserve fund, or both, as the case might be, should be reimbursed up to the extent of the loss theretofore charged off.

3. Under such circumstances, if the value of such real estate is more than the cost, it should be carried on the books of the company at the amount bid, which includes court costs and taxes.

4. In the event property is purchased at foreclosure proceedings by a building and loan association for an amount in excess of the amount loaned thereon, such excess being a sum to pay court costs and taxes, the real estate should be carried on the books at the amount of the loan, and court costs and taxes should be charged to the undivided profit fund or to the reserve fund.

Respectfully,

GILBERT BETTMAN,
Attorney General.

2819.

APPROVAL, BONDS OF VILLAGE OF OHIO CITY, VAN WERT COUNTY,
OHIO—\$19,125.00.

COLUMBUS, OHIO, January 13, 1931.

Retirement Board, State Teachers Retirement System, Columbus, Ohio.