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1. INSURANCE—NET EARNINGS—SECTIONS 9357-J (a) G. C.—WHEN APPLIED TO THE (d) CORPORATION AND TO PENNSYLVANIA-COOPERATIVE ASSOCIATION MEANS GROSS EARNINGS LESS EXPENSES OF OPERATION.
2. BOTH COMPANIES HAVE EARNINGS FROM WHICH TO COMPUTE NET EARNINGS TO DETERMINE ELIGIBILITY OF PREFERRED STOCKS AS INVESTMENTS FOR DOMESTIC LIFE INSURANCE COMPANIES.
3. PREFERRED STOCK AND COMMON STOCK ARE CAPITAL STOCK.
4. “STOCKS”—TEN PER CENT OF OUTSTANDING STOCKS INCLUDES PREFERRED STOCK AND COMMON STOCK.
5. THE (d) COMPANY, A CORPORATION FOR PROFIT, NOT A COOPERATIVE ASSOCIATION—EARNINGS BELONG TO STOCKHOLDERS.
6. INVESTMENT IN PREFERRED STOCK OF PENNSYLVANIA-COOPERATIVE ASSOCIATION—LEGAL INVESTMENT—NET EARNINGS AND INVESTMENT IN PREFERRED STOCK MUST MEET REQUIREMENTS OF SECTION 9357-J G. C.

SYLLABUS:

1. Net earnings as used in Section 9357-J(a) of the General Code when applied to the (d) corporation and to the Pennsylvania-Cooperative Association means gross earnings less expenses of operation.

2. Both the (d) company and the Pennsylvania-Cooperative Association have earnings from which to compute net earnings as set forth in Section 9357-J(a) of the General Code for determining the eligibility of preferred stocks as investments for domestic life insurance companies.

3. Both the preferred stock and the common stock of the (d) company are capital stock.

4. The term "stocks" as used in Section 9357-J(c), General Code, namely, "ten percent of outstanding *stocks*" includes both preferred stock and common stock."

5. The (d) company is a corporation organized for profit and is not a cooperative association; it therefore follows that neither its working capital reserves nor any of its profits may be allocated to any one on the basis of patronage but that its earnings belong to its stockholders.

6. The investment by (a) life company in the preferred stock of the Pennsylvania-Cooperative Association is a legal investment provided that the net earnings of said company are such as to meet the requirements of Section 9357-J, General Code, and provided the other requirements of Section 9357-J with reference to the investment in preferred stocks are met.

Columbus, Ohio, March 5, 1946

Hon. Walter Dressel, Superintendent of Insurance
Columbus, Ohio

Dear Sir:

Your request for my opinion reads as follows:

"This department conducted an examination of three domestic companies, which I shall designate as (a) a domestic legal reserve life insurance company; (b) a domestic mutual fire insurance company; (c) a domestic mutual casualty company. As a result of this examination, a question has arisen as to the legality of certain investments of the *life insurance company*. This examination was conducted by this department, together with the state of South Carolina, representing Zone 2. Each of these companies is subject to interlocking directorates and management.

There appears in this picture, another corporation organized under Ohio laws, for profit. I shall designate this corporation as (d).

The (c) company owns 94.6% of the common stock of (a) life company. The (a) life company owns 385 shares, \$75.00

par value, 4% preferred stock of the (d) company. The (d) company is a service company rendering to various member companies; accounting, telephone, advertising, and other services for which each company is charged for the value of services rendered.

The examiners treated the investment of (a) life company in the (d) company as a non-admitted asset in the financial statement. The examiners treat this investment as not being qualified as to net earnings under General Code Section 9357-J(c). The earnings of the (d) company are exempt from income tax under the provisions of internal Revenue Code, Chapter I, Section 101, which as a result of an interpretation by the Internal Revenue Department exempts cooperatives and their affiliates. The company contends the preferred stock is working capital and not capital stock, consequently, not entitled to treatment as capital stock in the distribution of margins. If this preferred stock is not capital stock, the life insurance company would be limited to 10% of the capital stock (common stock only) amounting to the sum of \$250.00. The sections of the General Code applicable to this set of facts is General Code Section 9357-J(a) which reads as follows:

'In the preferred stocks of any company organized under the laws of the United States or of one of the several states, upon which the average annual net earnings for a period of not less than five fiscal years preceding purchase thereof, after deduction of interest on all mortgages, bonds, debentures, and funded debts and proper charges for replacements, depreciation and obsolescence, shall have been at least four times the amount which may be required to pay the dividends on such preferred stocks, and in which the mortgages, bonds, debentures, funded debts and preferred stocks shall not in the aggregate exceed sixty per cent of the total of the capitalization of such company, including mortgages, bonds, debentures, funded debts and preferred and common stocks.'

and Ohio General Code Section 9357-J(c) which reads as follows:

'No domestic life insurance company shall at any time have invested a sum exceeding one per cent of its admitted assets as of the preceding December 31 in the bonds, notes, debentures and preferred stocks of a particular corporation, nor excepting for investments authorized under paragraph H hereof, shall it at any time own more than ten per cent of the outstanding stocks, notes, debentures and bonds of any corporation.'

Among the various assets owned by the life insurance company are Certificates of Preferred Stock in the Pennsylvania-Cooperative Association in the amount of \$50.00 bearing interest at 4%. Our investigation discloses the Pennsylvania-Cooperative Association was organized under Pennsylvania Cooperative Laws.

The capitalization of the (d) company as of December 31, 1945 is as follows:

Capital Stock, common	\$ 2,500.00
Capital Stock, 4% preferred	292,406.25
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Total capitalization	\$294,906.25

The book value of the life company's investment in (d) company is \$28,875.00 of 4% preferred stock. The total outstanding stock of (d) company amounts to \$294,906.25, ten per cent of which is \$29,490.00.

I desire your opinion upon the following questions:

1. What is meant by NET EARNINGS as used in Section 9357-J(a) of the General Code of Ohio when applied to operating circumstances used by (d) and the Pennsylvania-Cooperative Association?
2. Do either the (d) company or the Pennsylvania-Corporation have earnings from which to compute net earnings as set forth in Section 9357-J(a) of the General Code, for determining the eligibility of preferred stocks as investments for domestic life insurance companies?
3. Considering the organization and the method of operation of (d) company, is the preferred stock issued by the said corporation CAPITAL or CAPITAL STOCK as used in 9357-J(c)?
4. Does the language used in General Code, Section 9357-J(c) to wit: 'Ten per cent of outstanding stocks, notes, debentures and bonds of any corporation', contemplate including Capital, or obligation of preferred stock, as outstanding stock?
5. May the working capital reserves of (d) company be properly considered as margins, subject to be allocated to the insurance companies and others, on the basis of their patronage?
6. Is the investment by the life company, of \$50,000 in preferred, 4% stock of the Pennsylvania-Cooperative Association, a legal investment and qualified as such under General Code Sections 9357-J(a) or (c)?

I realize the technical questions involved, and suggest that you communicate with this department, since we have certain documents which will benefit you in your study of the matter. I have hesitated to incorporate the same, due to the voluminous character of the documents."

I shall answer your questions in the same order as presented in your request.

"1. What is meant by NET EARNINGS as used in Section 9357-J(a) of the General Code of Ohio when applied to operating circumstances used by (d) and the Pennsylvania-Cooperative Association?"

An examination of the articles of incorporation of the (d) company filed with the Secretary of State discloses that such company is an Ohio corporation organized for profit under former Section 8728-1, General Code of Ohio (108 O. L. Pt. 2, 1278). An examination of the photostatic copy of the articles of the association of the Pennsylvania-Cooperative Association discloses that it is a cooperative association organized under the statutes of Pennsylvania (Purdon's Penna. Statutes, Title 14, Section 81 to 106, inclusive).

The statutes of Ohio do not define the term "net earnings" or "earnings" nor is the same defined by the articles of incorporation of the (d) corporation or by its Code of Regulations. The (d) corporation is not a cooperative association, therefore, the definition of net earnings applicable to this corporation is the same as for any other corporation for profit.

The Pennsylvania-Association is a cooperative association but I think that as such it is not precluded from having "earnings" and "net earnings" under the Pennsylvania laws although it can be said that its net earnings, subject to the rights of the stockholders, may be distributed to its patrons on the basis of their patronage. Title 14, Section 82, Purdon's Penna. Statutes, authorizes the formation of such associations "having capital stock," and Section 84 of the same act provides for the filing of the articles which must contain, among other things, the following:

"V. The amount of its capital stock, and the number and par value of shares into which it is divided, the names and post-office addresses of the subscribers, the number of shares sub-

scribed by each, and the amount of capital actually paid into the treasury, which shall not be less than ten per centum of the capital stock.”

Section 86 of the same act provides as follows :

“Any association may transact or do business with or for patron stockholders or patrons not stockholders, and may issue and sell its preferred stock to patrons or non-patrons of the association; but common stock of the association shall be sold to patrons only; and the certificate of common stock shall contain a provision that the association shall have an option to redeem the stock at par value plus accrued dividends when the owner thereof has for a period of twelve months, done no business with the association, and shall contain a further provision no sale of stock shall be valid without the written consent of the association, and, if the association withholds its consent to such sale, then the association shall redeem such stock at par value plus accrued dividends. Dividends on the common stock shall be paid only after dividends are paid on the preferred stock, and the required surplus fund set aside, and shall be not greater than six per centum per annum, except as hereinafter provided. Dividends on preferred stock shall be not greater than six per centum per annum and shall be cumulative.

After payment of the dividend on the preferred stock, and after making provision from its *net earnings* for the reserve fund, as hereinafter provided, the remainder of the *net earnings* of the association, not required for dividends on the common stock, may, in the discretion of the directors, be distributed as a patronage refund. Patron stockholders shall be entitled to patronage refunds at double the rate of patronage refunds to which non-stockholder patrons shall be entitled. Patronage refunds may be credited to the accounts of non-stockholders in the purchase of capital stock of the association.” (Emphasis added.)

and Section 96 of this act also provides as follows :

“Any such association, after making provision for the payment of dividends on the preferred stock, and before payment of dividends on the common stock, or the distribution of any patronage refund or dividend, shall set aside ten per centum of the total *net earnings*, annually, for a reserve fund, until the reserve fund shall equal at least thirty per centum of the paid up capital stock. The reserve fund shall be available for such purposes as shall be designated and authorized by the vote of two-thirds of the members of the board of directors at a duly assembled meeting of said board, subject to such limitations

and conditions as shall be provided for in the by-laws of the association.” (Emphasis added.)

It would seem that the Pennsylvania legislature in passing the above mentioned statutes contemplated that such association would have “net earnings” and that subject to the provisions for payment of dividends to its stockholders and making provisions for its reserve fund, the association could distribute the remainder of the “net earnings” as a patronage refund.

“Earnings” and “net earnings” also are not specifically defined by the Pennsylvania statutes or by the articles of the Pennsylvania-Cooperative Association or by its by-laws and I can see no reason for giving such terms any different meaning than that which is applicable to the (d) corporation or to any other corporation.

Let us now proceed to a definition of the term “net earnings.” “‘Net income’ or ‘earnings’ are the products of a business, deducting the expenses only.” Word & Phrases, Perm. Ed. Vol. 14, p. 26, (citing Jones & Nimick Mfg. Co. v. Commonwealth, 69 Pa. 137, 139). Again on page 29: “The word ‘earnings’ has been construed to signify money, and ‘net earnings’ the sum received in excess of operating expenses.” Clark v. Vandalia R. Co., 172 Ind. 409, 86 N. E. 851, 854.

In Union Pacific Railroad Company v. U. S., 99 U. S. 402, 419, the court construed the words “net earnings of the road” (railroad). The court said:

“These *earnings*, however, must be regarded as embracing all the earnings and *income* derived by the company from the railroad proper * * *.” (Emphasis added.)

“Having considered the question of *receipts or earnings*” the court proceeded to define “net earnings” by stating (p. 420):

“As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves.”

“Earnings” then means “income” or “receipts.” “Gross earnings” means all of the “receipts” or “income” derived from the corporation’s operations. “Net earnings” means “gross earnings” less expenses of operation.

It follows then that both the (d) company and the Pennsylvania-Cooperative Association may have "earnings" and "net earnings."

"2. Do either the (d) company or the Pennsylvania-Corporation have earnings from which to compute net earnings as set forth in Section 9357-J(a) of the General Code, for determining the eligibility of preferred stocks as investments for domestic life insurance companies?"

This question has already been answered, namely, that both the (d) company and the Pennsylvania-Cooperative Association may have net earnings, giving the term "Net earnings" as found in Section 9357-J(a), General Code, the meaning as hereinbefore stated. It therefore follows that the preferred stocks of these companies may be proper investments if the net earnings of said companies are such as to fulfill the requirements set forth in paragraph (a) and if the other requirements of Section 9357-J are met.

"3. Considering the organization and the method of operation of (d) company, is the preferred stock issued by the said corporation CAPITAL or CAPITAL STOCK as used in 9357-J(c)?"

The articles of incorporation of the (d) company provide in part as follows:

"FOURTH. The total number of authorized shares which may be issued by this corporation is ten thousand (10,000), of which twenty-five hundred (2500) shares shall be common stock without nominal or par value and seventy-five hundred (7500) shares shall be preferred stock of the value of seventy-five dollars (\$75.00) each. There shall be but one class of common stock.

The terms and provisions under which the preferred stock shall be issued are as follows:

The holders of the preferred stock shall be entitled to a dividend of four percent (4%) per annum, payable semi-annually, out of the surplus profits of the corporation for each year in preference to all other stockholders, and such dividends shall be cumulative, but deferred dividends shall not bear interest."

In your request for this opinion, on page 2 thereof, you state as follows:

"The capitalization of the (d) company as of December 31, 1945, is as follows:

Capital Stock, common	\$ 2,500.00
Capital Stock, 4% preferred	292,406.25

Total capitalization	<u>\$294,906.25</u> "
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I am in accord with your view that both the common stock and the preferred stock of the (d) corporation constitute capital stock. The term "capital stock" does not appear in any place in the Ohio General Corporation Act. Capital stock is, however, a term of uncertain meaning, sometimes referring to authorized capital stock, sometimes to issued stock, and sometimes to a capital paid in. See 10 O. J., Corporations, Section 155. In the case of *State v. Jones*, 51 O. S. 492, the court quoted with approval from *Beach on Private Corporations*, Section 466, as follows:

"There is a distinction between the capital of a corporation and its capital stock, though they are often used as interchangeable terms. The capital stock is clearly not the same as property possessed by the corporation; for the capital stock remains fixed although the actual property of the corporation varies in value and is constantly increasing or diminishing in amount. What the amount of the capital shall be is within the discretion of the managers, but the amount of the capital stock is limited and determined by the charter and the laws governing it."

The general corporation acts does not contain the terms "common stock" and "preferred stock" although it does not prohibit the designation of shares as such. In 10 O. J., Corporations, Section 162, is the following statement:

"The shares into which the capital stock is divided are classified into different kinds; the principal classification is into common stock and preferred stock."

Section 9357-J(c) to which you refer does not use the term "capital" or "capital stock" so I am somewhat at a loss to determine what you mean by this question. As before stated, I am of the opinion that the preferred stock issued by the (d) corporation is capital stock.

"4. Does the language used in General Code, Section 9357-J(c) to wit: 'Ten per cent of outstanding *stocks*, notes, debentures and bonds of any corporation', contemplate including capital, or obligation of preferred stock as outstanding stock?"

Section 9357-J(a), General Code, authorizes the investment by a life company in the preferred stocks of any company provided such stock has certain net earnings as more fully set forth therein and subject to the limitation set forth in paragraph J(c) of this same statute that it shall not own "more than ten percent of outstanding *stocks*, notes, debentures and bonds of any corporation". In this same section it should be noted that the term "preferred stock" has been used in three different places while in the latter part of paragraph J(c) in stating that such investing life companies shall not "at any time own more than ten percent of the outstanding *stocks*", of any one corporation, the word "*stocks*" is not qualified in any way. I should think, therefore, that the legislature had in mind using the term stocks to include both the preferred and common stock, subject, of course, to the limitation that the life company could only invest in *preferred stock* but that in computing the permitted amount of investment in preferred stock, the investing company would be at liberty to consider ten percent of both the preferred and common stocks.

- "5. May the working capital reserves of (d) company be properly considered as margins, subject to be allocated to the insurance companies and others, on the basis of their patronage?"

This last question is probably based on your claim that the (d) corporation is a cooperative association, which I think is not well taken. While the (d) corporation seems to be closely associated with cooperative associations, it is of itself not a cooperative association. As has been previously pointed out, it is a corporation organized for profit having stockholders and the earnings of said company belong to the stockholders as such. Such company would not be authorized to make any distribution of its earnings to its patrons, if it had patrons, on the basis of their patronage.

You have made some reference to the fact that "the earnings of this company are exempt from income tax under the provisions of the Internal Revenue Code, Chapter I, Section 101 which as a result of an interpretation by the Internal Revenue Department exempts cooperatives and their affiliates." This ruling by the Internal Revenue Department can not have the effect of transforming corporations organized for profit under the Ohio corporation statutes into cooperative associations.

“6. Is the investment by the life company, of \$50,000 in preferred, 4% stock of the Pennsylvania-Cooperative Association, a legal investment and qualified as such under General Code Sections 9357-J(a) or (c)?”

Section 9357-J(a) authorizes the investment by a life company in the preferred stocks of any *company* organized under the laws of the United States or one of the several states, while (c) of the same section authorizes the owning of not more than 10% of the outstanding stocks of any *corporation*. The Pennsylvania statutes under which the Pennsylvania-Cooperative Association is incorporated do not specifically use the term “company” or “corporation”, nevertheless, an examination of these special statutes indicates that such associations have all the powers of corporations. In Ohio also, not all corporations are organized under the General Corporation Act. There are many different classes of corporations organized under special statutes. In some instances, the term “corporation” is not used but the term “association” is used as, for instance, building and loan associations (Section 9643, General Code); cooperative agricultural associations (Section 10186-1, General Code); fraternal associations (Section 9743, General Code); and to this list others could be added. I should think, therefore, that under Section 9357-J, the term “company” or “corporation” is broad enough to include an investment in a Pennsylvania cooperative association organized under Purdon’s Penna. Statutes, Title 14, Section 81 to 106, inclusive.

I am informed that the authorized capital stock of the Pennsylvania-Cooperative Association consists of 20,000 shares of preferred stock at \$25.00 par, or a total par value of \$500,000, and 40,000 shares of common stock at \$25.00 par value, or a total par value of \$1,000,000. I am also informed that according to the last return filed with the Secretary of the Commonwealth of Pennsylvania, the issued and outstanding stock is as follows:

<i>“Class</i>	<i>No. of Shares</i>	<i>Par Value</i>
Preferred	8,000	\$200,000
Common	20,000	500,000
		<hr/>
	Total	\$700,000”

Ten percent of the outstanding stocks of this company would amount to \$70,000 which is more than the investment by the (d) company of \$50,000 in preferred 4% stock of this cooperative association.

Section 9357-J(c) of the General Code also provides that no domestic life insurance company shall at any time have invested a sum exceeding 1% of its admitted assets as of the preceding December 31 in the notes, bonds, debentures and preferred stocks of the particular corporation. I am informed that the admitted assets of the (d) company as of December 31, 1944, exceeded the sum of \$8,000,000 so that this investment in the Pennsylvania-Cooperative Association is within the 1% limitation set forth in the statute.

In specific answer to your questions, I am therefore of the opinion that:

1. Net earnings as used in Section 9357-J(a) of the General Code when applied to the (d) corporation and to the Pennsylvania-Cooperative Association means gross earnings less expenses of operation.

2. Both the (d) company and the Pennsylvania-Cooperative Association have earnings from which to compute net earnings as set forth in Section 9357-J(a) of the General Code for determining the eligibility of preferred stocks as investments for domestic life insurance companies.

3. Both the preferred stock and the common stock of the (d) company are capital stock.

4. The term "stocks" as used in Section 9357-J(c), General Code, namely, "ten per cent of outstanding *stocks* includes both preferred stock and common stock."

5. The (d) company is a corporation organized for profit and is not a cooperative association; it therefore follows that neither its working capital reserves nor any of its profits may be allocated to any one on the basis of patronage but that its earnings belong to its stockholders.

6. The investment by (a) life company in the preferred stock of the Pennsylvania-Cooperative Association is a legal investment provided that the net earnings of said company are such as to meet the requirements of Section 9357-J, General Code, and provided the other require-

ments of Section 9357-J with reference to the investment in preferred stocks are met.

Respectfully,

HUGH S. JENKINS,
Attorney General.