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Buying Your Own Stock

THE question of how to treat purchases by a corporation of its own capital stock, of late has assumed more than academic importance because of the economic situation which has existed during the past year and a half. A depressed stock market has offered rare opportunities to corporations for the purchase of their own shares. Many corporations have found themselves in a position where decreased volume of business has made desirable a smaller amount of capital to which dividend responsibilities attach. Smaller earnings, in some cases, have interfered with the continuance of established rates of dividends. A smaller number of shares outstanding might permit an untarnished dividend record, or at least a dividend distribution acceptable to shareholders. Many corporations have taken advantage of the opportunities afforded by the market, and have purchased their own shares. Not a few corporation officials have been perplexed by the accounting problem of how to treat the stock so acquired, and, where the law requires that such shares may be purchased only out of surplus, how to treat the surplus so used.

The power of a corporation to acquire its own capital stock by purchase, is a matter to be governed by the statutes applicable to the jurisdiction involved, or by the decided cases pertinent to the question. The accounting treatment to be accorded to such shares when purchased has been the subject of considerable controversy because of two sharply opposed theories concerning the significance of such transactions. The two theories may be referred to, respectively, as the commodity theory, and as the capital stock adjustment theory.

The commodity theory of capital stock is based on the principle that exchanges make a ready market for capital stocks, that the stocks are bought and sold, like merchandise, and, that once a corporation has sold and issued its stock, such stock takes on the character of merchandise, regardless of the hands into which it may fall. This, coupled with the fact that certain statutes governing corporations forbid the reduction of capital stock without formal action, furnishes ground for the argument that stock once issued and reacquired for value, otherwise known as treasury stock, properly may be recognized as an asset. Thus is afforded a theoretical reason for ignoring any accounting relationship between treasury stock and the capital stock account and a basis on which to predicate a theory of gain or loss in subsequent treasury stock transactions.

The capital stock adjustment theory is based on the principle that capital stock is

the representation of the capital fund in a corporate enterprise, that the issuance by the corporate enterprise of capital stock for value brings capital into the enterprise, and that the reacquisition of such stock for value takes capital out of the enterprise. In other words, prior to issuance, capital stock has capital-producing possibilities. When capital stock goes out, so to speak, capital comes into the enterprise. When capital stock is reacquired by purchase, and comes in, capital goes out to the party who surrendered the stock. Thus, a corporation is capitalized and decapitalized, and all capital stock transactions must be capital transactions reflecting fluctuations in the capital fund, or the economic capital, and not commodity transactions.

The case of Borg, et al v. International Silver Company (Circuit Court of Appeals, Second District, August 4, 1925, 11 Federal Reporter, 2nd Series, 147 No. 372) furnishes a basis for discrediting the commodity theory of treasury stock. In that case the court said, concerning shares of the corporation shown on its balance sheets for fifteen years, as "in treasury" and deducted from the capital stock, which treasury stock opposing counsel had argued should have been carried among the assets either at cost—as prescribed by the Interstate Commerce Commission—or at par, without reduction of the assets:

> "To carry the shares as a liability, and as an asset at cost, is certainly a fiction, however admirable. They are not a liability, and on dissolution could not be so treated, because the obligor and obligee are one. They are not a present asset, because, as they stand, the defendant cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations. In order to indicate this potentiality, it may be the best accounting to carry them as an asset at cost, providing, of course, all other assets are so carried. Even so, a company which revalued its assets might properly carry them at their sale value when the revaluation was made. In any event there can be no ambiguity in stating the facts more directly, as the defendant did, that is, in treating the shares as not in existence while held in the treasury, except as a possible source of assets at some future time, when by sale at once they become liabilities and their proceeds assets. It makes no difference whether this satisfies ideal accounting or not."

Further weight to this opinion concerning the theory of treasury shares is found in the fact that they do not receive dividends and cannot be voted, for which see 14 Corpus Juris 904 (Sec. 1400) (18) Corporations (a) In Respect of Its Own Shares, to wit:

> "Corporations have, as hereafter seen, a qualified power to deal in their own shares. . . . But stock thus owned or held by the corporation cannot be voted at corporate elections, and this rule applies with equal force to stock held by trustees for the benefit of the corporation. Some statutes expressly provide that stock owned by a corporation shall not be voted directly or indirectly."

The foregoing opinion may be taken not only to discredit the commodity theory of treasury stock, but to support the capital stock adjustment theory. For financial purposes treasury shares have the same status as if they had been retired. As the Court says elsewhere, "Indeed, the only difference between a share held in the treasury and one retired is that the first may be resold for what it will fetch on the market, while the second has disappeared altogether." (Enright v. Heckscher, 240 F. 863, 874, 153 C. C. A. 549 (C. C. A. 2); Rural Homestead Co. v. Wildes, 54 N. J. EQ. 668, 35 A 896; Cook on Corporations, Sec. 286.)

One point further may be made before leaving the commodity theory. In order to make it operate consistently where it is used as a basis for determining profits and

losses on treasury stock, it should be applied from the beginning of the capital transactions. Stated more concretely, any recognized gain or loss should be determined by comparing purchase prices with original sales prices. If capital stock is a commodity after being repurchased, it must have been a commodity when first sold. The corporation must have gained or lost money buying back at a lower or a higher price, capital stock originally sold at a given price. This analogy needs to be carried but one step further to have it reach the absurd point where all corporations are considered as being merchandisers of capital stocks, rather than organizations making use of capital stock as a means of assembling units of capital for the purpose of engaging in some line of business.

Approaching now the relation of surplus, in connection with the purchase by a corporation of its own shares of capital stock, it becomes necessary to examine the legal concepts of capital and capital stock.

In re: Fechheimer Fishel Co. (212 Fed. Rep. 357), the Circuit Court of Appeals, citing the Supreme Court of Illinois in Commercial National Bank v. Burch (141 Ills. 519, 31 N. Y. 420, 33 A. St. Rep. 331), said: "The capital stock of a corporation is a fund set apart for the payment of its debts, and the directors . . . hold it in trust for that purpose." In Topken, Loring and Schwartz, Inc. v. Schwartz (249 N. Y. 206), the Court of Appeals said, "The capital of a corporation is held in trust for its creditors, so that any agreement to purchase stock from a stockholder, which may result in the impairment of capital, will not be enforced, or will be considered illegal if the rights of creditors are affected." In Cross v. Beguelin (252 N. Y. 262), the Court of Appeals said, citing Trotter v. Lisman (209 N. Y. 174) and First Trust Co. v. Ills. Cent. R. R. Co. (256 Fed. Rep. 830), "The assets constitute a trust fund for creditors."

Supplementing the doctrine enunciated in these pronouncements, there is the well-settled principle of corporation law that corporations may not reduce their capital stock without due process of law, which takes the form in most jurisdictions of filing an amendment to the charter. Thus, it appears that a corporation, not having filed notice of intention to reduce its capital stock, and buying its own shares when its assets were equal in amount only to the amount of its debts and capital stock outstanding previous to the purchase, would be adjudged to have suffered an impairment of capital.

Based on this conclusion, and in order to avoid such condition, it follows that before a corporation may release any individual shareholders from their investment in the capital fund, the corporation, as an entity, must have other funds to substitute therefor. It is on this theory, presumably, that into certain laws governing corporations have been introduced the provision that a corporation may not purchase its own stock, except out of surplus. The effect, therefore, is to maintain the same amount of capital stock after, as before, the purchase, but to ascribe the ownership of the whole amount after the purchase, in part to the individual holders as a group, and in part to the corporate entity. In other words, the corporation, by act of purchase, has transferred an undistributed interest in the net assets, from surplus to capital, in order that certain individuals may withdraw their capital interest.

In New York state, there is no statutory regulation in the corporation law concerning the purchase by a corporation of its own stock. The decided cases seem to sanction the action where a corporation has sufficient surplus, but in the case of Cross v. Beguelin (252 N. Y. 262) the Court of Appeals said: "When made, the agreement with Ferdinand Cross was valid. Then a surplus existed. After the corporation became financially embarrassed and the surplus shrank to a deficit, the agreement became unenforceable as against the Corporation (Penal Law, Sec. 664)." The Penal

Law (Section 664, as amended by L. 1924, Chapter 221) makes the act of purchasing stock a misdemeanor when the stock is purchased in the absence of surplus, viz.:

"A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended . . . to apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, is guilty of a misdemeanor."

Delaware, the arch-crusader for freedom of corporate action, has drawn her law without specific reference to surplus, but apparently with the same effect:

"Every corporation under this chapter shall have the power to purchase, hold, sell and transfer shares of its own capital stock, provided that no such corporation shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital of the corporation."

The Ohio statutes are more definite. They provide as follows:

"A corporation may purchase shares of any class issued by it: . . . (c) To the extent of the surplus of the aggregate of its assets over the aggregate of its liabilities plus stated capital, when authorized by the affirmative vote of the holders of two-thirds of each class outstanding, ... A corporation shall not purchase its own shares except as provided in this section, nor when there is reasonable ground for believing that the corporation is unable, or by such purchase, may be rendered unable to satisfy its obligations and liabilities."

In the Ohio statutes, the purpose of the restrictive provision is made clear. Surplus is defined. The danger of permitting other procedure is indicated in the reference to creditors. The intent obviously is to prevent stockholders from withdrawing their capital in a form which is liquid, unless such liquidity is the result of their own efforts, and not something advanced by creditors. If cash, or other current assets, in excess of the amount of surplus, were used to buy the stock of the corporation, current creditors might be left with only physical property or other assets of questionable value available to satisfy their claims.

Two principles logically may be advocated on the foregoing grounds in connection with the purchase by a corporation of its own capital stock: first, the stock so acquired should be treated as an adjustment of the capital stock account, and not as an asset; second, that an amount equal to the purchase price be transferred out of surplus, and be made unavailable for appropriation as dividends.

Various problems are created in practice by different kinds and classes of capital stock and by corporate and accounting practices. Some capital stock has par value. Other stock has no par value. Preferred stocks have various features which raise serious questions concerning the respective positions of preferred and common shareholders in relation to surplus. Common capital stock sometimes is acquired by donation. Both preferred and common stocks may be purchased at either a premium or a discount. Some of the problems attending these matters will be discussed in an article to follow in the next Bulletin.

Classification

CLASSIFICATION comes to the fore again because of consideration which it has had and is to have by the two national accountancy bodies, namely, The