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Assessments on Stock of Corporations Organized Under the Laws of California

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From a very general examination of a summary of the corporation law of the various states, it would appear that California is one of the few states where directors of a corporation can levy assessments on fully paid stock, and it may, therefore, be of interest to look into the law and the accounting questions in connection therewith:

Legal Provisions

The following is a summary of the more important provisions regarding assessments:

"Directors may levy assessments for the purpose of paying expenses, conducting business or paying debts.

"No assessment must exceed 10% of the amount of the capital stock.

"The order levying an assessment must specify the amount thereof; fix a day subsequent to the full term of publication of the assessment notice on which the unpaid assessments shall be delinquent, not less than thirty nor more than sixty days from the making of the order; and a day for the sale of delinquent stock, not less than fifteen nor more than sixty days from the date the stock was declared delinquent.

"The notice of assessment must be served on the stockholder or sent to him through the mail and advertised in a newspaper once a week for four successive weeks.

"The secretary shall also publish in a newspaper a notice declaring stock delinquent and specifying a day on which the stock shall be sold at public auction.

"When sold at auction so many shares are sold of each parcel of stock as may be necessary to pay delinquent assessments, together with advertising and expenses of sale.

"If at the sale of stock no bidder offers the amount of assessments and the costs, the same may be bid in and purchased by the corporation at the amount of assessment and costs; and the

* Contributed by a correspondent.

amount of the assessment cost and charges must be credited as paid in full on the books of the corporation and entry of the transfer of the stock to the corporation made on the books thereof. While the stock remains the property of the corporation, it is not assessable nor must dividends be declared thereon. Stock so purchased is held subject to the control of the stockholders who may make such disposition of the same as they deem fit.

"No assessment must be levied while any portion of a previous one remains unpaid."

Taking the minimum notice that must be given, it would appear that if all assessments are paid, assessments not exceeding 10% could be levied each month, while if any assessments were delinquent the minimum period would be each 45 days.

Advantages of being able to Levy Assessments

It will be understood that where a corporation cannot readily borrow money either by loan or by an issue of bonds the ability to levy an assessment is of considerable advantage, especially in view of the fact that according to California law bonds cannot be issued in excess of the capital stock. It also enables a company to start with a comparatively small capital and secure its cash requirements from time to time as is found necessary. This is frequently done by mining or oil companies where assessments are levied from time to time to pay for development work until the company gets on an earning basis.

Possible Abuses

The principal opportunity for abuse of the provision is the power which it gives to a board of directors to "freeze out" small stockholders. It has been alleged in several cases that directors have levied assessments from time to time until the small stockholders became weary of paying assessments and either let their stock become delinquent or sold it at a comparatively small price. In the case of a corporation controlling the stock of another corporation this is particularly easy, as the holding company, through its control of the directors of the subsidiary, can levy assessments which the minority stockholders must either pay or lose their stock through its becoming delinquent. The cash paid by the holding company on its assessment can, of course, easily be gotten back as a loan from the subsidiary.

Assessments Levied on Preferred Stock

Prior to 1907 no specific provision existed in the California statutes for different classes of stock, and before that time practically all California corporations had only one denomination of stock.

In 1907 the following clauses were added:

> Corporations may by their articles of incorporation provide for the classification of their capital stock into preferred and common stock.
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> The articles of incorporation shall also state, in clear and succinct manner the nature and extent of the preference granted, and except as to the matters and things so stated, no distinction shall exist between said classes of stock or the owners thereof; provided, however, that no preference shall be granted nor shall any distinction be made between the classes of stock either as to voting power or as to the statutory or constitutional liability of the holders thereof to the creditors of the corporation.

No distinction is made in the code regarding the levying of assessments on different classes of stock, and in two cases which have occurred in recent years corporations having both preferred and common stock have levied assessments equally on both classes of stock. In at least one of the cases the nature and extent of the preference granted to the preferred stock was "to receive from the surplus profits arising from the business of the corporation cumulative dividends as declared to the extent of 6% per annum *and no more* and on liquidation or dissolution of the company to receive the *par value* of the stock." In these circumstances, it seems that assessments paid by these preferred stockholders can never be repaid to them, and notwithstanding this it seems that, unless the articles specify that the preferred stock is non-assessable, the directors, if so inclined, could continue levying assessments on the preferred stockholders indefinitely, provided the company required funds to pay expenses, conduct its business or pay debts.

It would appear that when the amendment was made providing for the issue of preferred stock proper provision for safeguarding the interests of preferred stockholders in respect of assessments was not made. It would almost seem that as a matter of equity the preferred stockholders would be taken care of in court proceedings; but in the absence of case law the subject seems very debatable.

Treatment of Assessments on Books of Corporations

When an assessment is levied an entry should be made on the books charging "Assessment No. — Collectible" and crediting "Assessment No. — Account." If the assessment is paid in full the cash will be credited to the "Assessment Collectible" account and if any stock is delinquent and is bid in by the corporation, it would seem that under the law the amount at which the company bid in the stock, *viz.*, the amount of the assessment and costs, should be credited to "Assessment Collectible" account for the amount of the assessment and to "Assessment Expenses" for the balance. Questions then arise—first, as to the treatment of the credit balance on assessment account; and second, as to the treatment of the stock bought in by the company.

Treatment of Credit Balance on Assessment Account

It is difficult to see why in all cases this could not, if desired, be credited to surplus account and if the assessment has been levied to make good operating losses it would naturally be credited to that account. If, however, the assessment has been levied to provide for construction or development expenditure, it could be shown either as a separate item in the balance sheet immediately following capital stock, or it might be transferred to an account called "Reserve for Development" or "Reserve for Working Capital" and thus have the surplus account show only earnings from operations.

Treatment of Stock Bought in by Company

Inasmuch as the records show that the company purchased the stock at the amount of the assessment and costs, it would seem that the proper course would be to carry the stock at this value. If, however, it is desired to carry the stock at its par value, the difference between the par value and the cost should be credited to a capital surplus account or applied in reduction of goodwill or rights, franchises, etc., if such assets are carried on the books of the corporation. If carried at par it should preferably be shown as a deduction from the stock issued, and if shown as an asset it should not be included under the heading "Current Assets."

No objection could probably be taken to writing up the value of the stock to a reasonable figure at a later date, but it would not be proper to include such increase in the profits of the year nor even as an addition to surplus available for dividends. If, however, the stock is sold at a sum in excess of its book value there is no reason why the profit could not be credited to surplus account.

There seem to be advantages in carrying the stock at cost:

(*a*) It would show in the clearest manner the actual transactions which had occurred;

(*b*) It would not be shown as a deduction from the stock issued, which must frequently be an advantage on account of the desirability of showing the issued capital stock as being not less than the bonded indebtedness;

(*c*) If the company subsequently sells such stock it could credit surplus with any amount received in excess of cost, whereas if the stock were carried at par and sold at a price below par (which might reasonably be expected if some stockholders did not care to pay not more than 10% of the par value) the difference would have to be charged to surplus, or to some account such as "Discount on Stock," or to capital surplus if that account was credited with the difference between the cost and the par value.