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THE LEGAL STATUS OF TREASURY STOCK

SO LONG as corporations have followed the practice of acquiring their own stock,¹ lawyers, judges, and accountants have been in disagreement with each other and among themselves as to just what the transaction involves and as to how the acquisition should be shown on the company books. Only recently have law and accountancy begun to understand that neither can act independently of the other in determining its respective principles² with regard to so-called "treasury stock," i.e., stock issued by a corporation as fully paid to stockholders and subsequently reacquired by the corporation.³

The practice among accountants originally was to carry treasury stock on the corporate books as an asset.⁴ Particularly was this true when the stock had been acquired in anticipation of quick resale, even though the intent to resell would not seem to justify such an interpretation when the corporation by purchasing the stock "in effect is reducing the outstanding equity, not obtaining an asset."⁵ Moreover, during the time that the treasury stock

¹ See Briggs, *Treasury Stock and General Corporation Statutes* (1933) 55 JOUR. ACCOUNTANCY 329.

² See Hills, *Stated Capital and Treasury Shares* (1934) 57 JOUR. ACCOUNTANCY 202, 214: "Accountants must respect the law, and lawyers who serve with accountants must understand and appreciate the laws which govern the application of accounting principles... all who prepare and determine the form of financial statements owe to the public and to their clients the duty of presenting their work in a manner reflecting the legal as well as the economic consequences of the figures presented."

Wakefield, *When Lawyers and Accountants Disagree* (1934) 58 JOUR. ACCOUNTANCY 117: "To me, the reasons for difference seem in part also to be due to failure of each profession to think through to a clear understanding of the views of the other." See also Berle and Fisher, *Elements of the Law of Business Accounting* (1932) 32 COL. L. REV. 573. See also Hills, *Accounting in Corporation Law* (1937) 12 WISC. L. REV. 494, as to the need for a uniform law on various aspects of treasury stock.

³ As to corporate capacity, see Wormser, *The Power of a Corporation to Acquire Its Own Stock* (1915) 24 YALE L. J. 177.

⁴ See Bowles, *Treasury Shares on the Balance Sheet* (1934) 58 JOUR. ACCOUNTANCY 96, as to the various asset accounts in which treasury stock has been classified.

⁵ See PATON, *ESSENTIALS OF ACCOUNTING* (1938) 682, 684.

is held by the corporation the stock is not a valuable asset in the sense of one producing returns available for the creditors or stockholders upon liquidation.⁶

More recently, the trend among accountants has been away from treating treasury stock as an asset,⁷ and toward showing treasury stock on the books as a deduction from the capital stock outstanding, which in effect is a reduction of the capital stock.⁸ Unless the stock is actually retired, this is not completely true as the stock may be resold at any time without a new compliance with the various statutory requirements.⁹ In this more recent trend, the accountants have adopted the analysis of the transaction which has afforded the English courts a principal objection to permitting a corporation to acquire its own stock.

A more desirable accounting method of treating treasury stock would seem to be that advanced by Marple.¹⁰ After stating that

⁶ Hills, *Stated Capital and Treasury Shares* (1934) 57 JOUR. ACCOUNTANCY 202, 210: "On a liquidation of the corporation they would, of course, produce nothing for creditors. The mere fact that shares have once been issued does not place a value on them after they have been repossessed by the issuing corporation. . . ."

⁷ SANDERS, HATFIELD, AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 90, reports an investigation of balance sheets in which 45 per cent of the corporations showed treasury stock as an asset in 1933 and only 28 per cent in 1936. See Hills, *op cit.* *supra* note 6, at 210: "By common practice, supported in a limited sense, treasury shares have often been treated as an asset, a property, or something of value . . . but the present trend of judicial and legislative thought favors the fact and the statutory position that treasury shares are not an asset."

⁸ See I FINNEY, PRINCIPLES OF ACCOUNTING (1923) c. 8, p. 15: "The facts seem to be that when treasury stock is acquired the capital stock is at least temporarily reduced. The stock is not an asset but a potential liability or a State-granted right to create a liability. Until this right is exercised and the stock is re-issued, no asset exists and the capital stock outstanding is reduced." See also HATFIELD, ACCOUNTING—ITS PRINCIPLES AND PROBLEMS (1927) 182; BROWNELL, ACCOUNTING AND FINANCE (1929) 168; SANFORD, APPLIED ACCOUNTING PRINCIPLES (1931) 414; MCKINSEY AND NOBLE, ACCOUNTING PRINCIPLES (1939) 493; GILMAN, ACCOUNTING CONCEPTS OF PROFIT (1939) 163; ROEM AND KERRIGAN, ACCOUNTING METHOD (1942) 272. But see Bowles, *Treasury Shares on the Balance Sheet* (1934) 58 JOUR. ACCOUNTANCY 98, 102, stating that the asset theory has considerable support and giving advantages, though citing no authorities.

⁹ The New York Stock Exchange ruled that after January 29, 1934, in order to prevent abuses in purchase and resale of treasury stock, the extent of holdings of treasury stock must be reported to the Exchange monthly and notification given before each resale. See Holt and Morris, *Some Aspects of Reacquired Stock* (1934) 12 HARV. BUS. REV. 505.

¹⁰ See Marple, *Treasury Stock* (1934) 57 JOUR. ACCOUNTANCY 257, 262, showing in accounting form the entries from purchase to resale, with profit, or loss.

treasury stock is not an asset, and also that it is not a deduction from capital stock, he has suggested that each such purchase be handled by the creation of a new account entitled "Surplus Applied in Acquisition of Treasury Stock," with a debit to this account and a credit to the account of the asset given for the stock. The new account on the balance sheet would be shown as a deduction from the earned surplus account.¹¹ This entry would not affect the capital stock account, representing legal capital, and would not appear as an asset on the statement. Upon subsequent sale of the stock, the procedure would be to debit the account of the asset received, credit the new account, and transfer the profit or loss to the Capital Surplus account. By this method the assets expended for the stock would be reduced by the proper amount while the corporation is holding the stock; consequently the financial statement of the corporation would accurately reflect its condition and should the purchase be challenged, the courts, in applying their approved test of validity of the stock purchase, would not be innocently misled as to the true assets and surplus of the firm.¹²

Although accountants are beginning to depart from the practice of treating treasury stock as an asset, a considerable number continue to observe it. Probably the principal reason for the continuation of this practice is that the courts themselves continually refer to treasury stock as an asset.¹³

¹¹ Ballantine, *Drafting a Modern Corporation Law* (1931) 19 CALIF. L. REV. 465, 480: "... and by the requirement of section 342a that when a corporation acquires its shares under authority of section 342 (7) the earned surplus shall be reduced by the amount of the purchase price, but the stated capital shall not be affected thereby."

¹² For an interesting approach to the law and accounting in treasury stock transactions, see Montgomery, *Dealings in Treasury Stock* (1938) 65 JOUR. ACCOUNTANCY 466.

For a summary of the statutory law on treasury stock in the United States in 1932 see Briggs, *Treasury Stock and General Corporation Statutes* (1933) 55 JOUR. ACCOUNTANCY 329.

For a discussion of acquisition by a corporation of its stock by purchase, donation, and other manners, see Briggs, *Treasury Stock and the Courts* (1933) 56 JOUR. ACCOUNTANCY 171.

¹³ Glenn L. Martin Co. v. United States, 21 F. Supp. 562, 564 (D. Md. 1937); Mudd v. Lanier, ___ Ala. ___, 24 So. (2d) 550 (1946); Colorado Industrial Loan & Investment Co. v. Clem, 82 Colo. 399, 260 Pac. 1019 (1927); Porter v. Plymouth Gold Min.

Thus far judicial decisions have not clarified the legal status of treasury stock. Indeed, it could more truthfully be said that the character of the transaction is becoming increasingly confused with succeeding decisions. Only in England has the law on the point attained any semblance of stability and certainty. English courts have ruled in no uncertain terms that a corporation cannot purchase its own stock on the ground that there are statutes covering the manner of reduction of capital and that such a purchase would amount to capital reduction in an unauthorized manner,¹⁴ thereby making it much easier to avoid payment to, if not to defraud, creditors. The courts emphasize that creditors look to the assets of a corporation before extending credit, relying on the statutory procedure and protection as to reduction of assets; and further, that when the corporation gives a stockholder anything in return for surrender of his shares, the corporation's capital, in the sense of assets,¹⁵ is being reduced.

In this country there are seemingly numerous variations of the opposite, or so-called, American rule, which stated generally, is that, unless prohibited by statute or its charter, a corporation may purchase its own stock.¹⁶ To this simple rule have been

Co., 29 Mont. 347, 355, 76 Pac. 938, 940 (1904); *Robinson v. Bradley*, ... Tex., 141 S. W. (2d) 425 (1940); *Pabst v. Goodrich*, 133 Wis. 43, 113 N. W. 398 (1907).

In *Howe Grain & Merc. Co. v. Jones*, 21 T. C. A. 198, 51 S. W. 24 (1899), the court said, "... after paying plaintiffs the amount of their stock and dividends, it (the corporation) will have *left* more assets than necessary to pay its creditors."

¹⁴ In *Trevor v. Whitworth*, 12 A. C. 409, 416 (1887), Lord Hershell said: "What was the reason which induced the company in the present case to purchase its shares? If it was that they might sell them again, this would be trafficking in the shares, and clearly unauthorized. If it were to retain them, this would be an indirect method of reducing the capital of the company..."

Lord Macnaghten in his opinion states that if the power to purchase its own shares were found in the memorandum of association, it would be void.

For an analysis of the "English rule" see Glenn, *Treasury Stock* (1929) 15 VA. L. REV. 625, 629.

¹⁵ In *Trevor v. Whitworth*, supra, note 14, at 416: "The stockholders receive back the money subscribed, and there passes into their pockets what before existed in the form of cash in the coffers of the company, or of buildings, machinery, or stock, available to meet the demands of the creditors."

¹⁶ *Fremont Carriage Mfg. Co. v. Thomsen*, 65 Neb. 370, 91 N. W. 376, 378 (1902); *Kimball v. New England Roller Grate Co.*, 69 N. H. 485, 45 Atl. 253 (1899).

added, however, a succession of limitations. In the greater number of jurisdictions, the rule now prevailing seems to be that the purchase is valid and enforceable where the purchase can be made and paid for without prejudice to the rights of creditors and the remaining stockholders.¹⁷ Although such would seem a just and proper restriction adequate to protect those rights, the courts seldom explore sufficiently the possibilities included in the word "prejudice." Apparently, a corporation must be in financial distress threatening both creditors and stockholders with loss before the courts will determine that a stock purchase by it was made with prejudice to these interests.¹⁸ Should not the idea of prejudice to the interest of creditors and stockholders involve something more than mere loss of investment and credit?¹⁹ One survey in 1933²⁰ revealed that out of the 80 corporations canvassed which purchased their own stock, 69 during the year of purchase either by-passed or reduced payments of dividends. The reporter further stated that some investors could well be misled by the dividend reduction, and creditors may be induced to believe incorrectly that their position is being improved by a conservative dividend policy. The possible weakening of the

¹⁷ *Boggs v. Flemming*, 66 F. (2d) 859 (C. C. A. 4th, 1933); *Medical Arts Bldg. Co. v. Southern Finance and Development Co.*, 29 F. (2d) 969 (C. C. A. 5th, 1929); *Fleitman v. John M. Stone Cotton Mills*, 186 Fed. 466 (C. C. A. 5th, 1911); *Barrett v. W. A. Webster Lumber Co.*, 275 Mass. 302, 175 N. E. 765 (1931); *Schwerner v. Fry*, 212 Wis. 88, 249 N. W. 62, 66 (1933). The Texas law is indicated in 1 HILDEBRAND, *TEXAS CORPORATIONS* (1942) § 79.

¹⁸ See note 16 *supra*.

¹⁹ A limited number of courts have gone further, as evidenced by *Aydlett v. Majors and Loomis Co.*, 211 N. C. 548, 191 S. E. 31 (1937): "Agreement by a corporation to repurchase its own preferred stock from stockholder at stockholder's option held within corporation's power under charter and statutes, where corporation was solvent, *dividends on stock were being paid* (italics ours), and no rights of creditors were involved."

See also *Myers v. C. W. Toler & Co.*, 287 Mich. 340, 283 N. W. 603 (1939); *Pace v. Pace Bros. Co.*, Utah, 63 P. (2d) 590 (1937).

For a discussion of effect of stock acquisition on the intra-corporate relation among stockholders, see Levy, *Purchase by Corporation of Its Own Stock* (1930) 15 MINN. L. REV. 1, 22.

²⁰ Holt and Morris, *Some Aspects of Reacquired Stock, 1931-1933* (1934) 12 HARV. BUS. REV. 505.

financial structure of the corporation²¹ caused by the dumping of stock, market manipulations, and an over-extension of credit is more than a mere possibility should the corporation continue a repurchase and resale policy.

Another test by which courts determine the validity of corporate acquisition of treasury stock is the rule that the transaction is valid so long as the corporation has assets over and above its liabilities.²² Thus some courts have held that the corporation can purchase its stock so long as it is solvent.²³ In applying this rule, however, the courts are in conflict as to what should be included in liabilities, or as to what constitutes solvency. Apparently, the majority of the jurisdictions determine that a corporation is solvent, or that its assets exceed its liabilities by excluding capital stock as a liability,²⁴ whereas the minority determine that the corporation is solvent so long as its assets exceed its liabilities, including its capital stock.²⁵ The minority view, approved by

²¹ See Nussbaum, *Acquisition by a Corporation of Its Own Stock* (1935) 35 COL. L. REV. 971, 986, as to possible effect on stock exchanges by a corporation's purchasing its own stock. See also Levy, *Purchase by a Corporation of Its Own Stock* (1930) 15 MINN. L. REV. 1, 8; Note (1931) 31 COL. L. REV. 264, 274, for obligations owed by the corporation not to "bull" and "bear" the market, particularly in competition with its own stockholders.

²² Hoops v. Leddy, 119 N. J. Eq. 296, 182 Atl. 271 (1936); Wolf v. Heidritter Lumber Co., 112 N. J. Eq. 34, 163 Atl. 140 (1932); McCannon v. Lusk-Mitchell Newspapers, S. D. _____, 292 N. W. 82 (1940); Rasmussen v. Schweizer, 194 Wis. 362, 216 N. W. 481 (1928). See Marvin v. Anderson, 111 Wis. 387, 87 N. W. 226 (1901), and Gipson v. Bedard, 173 Minn. 104, 217 N. W. 139 (1927), to the effect that mere inability to pay debts as they mature does not prevent a corporation from being solvent within the meaning of this rule (assets exceed the liabilities).

²³ Sanford v. First Nat. Bank, 151 C. C. A. 314, 238 Fed. 298 (C. C. A. 8th, 1917); Dalton Grocery Co. v. Blanton, 6 Ga. App. 809, 70 S. E. 182 (1911); Stott v. Orloff, 261 Mich. 302, 246 N. W. 128 (1933); Cross v. Bequelin, 226 App. Div. 349, 235 N. Y. Supp. 336 (1929).

²⁴ Pender v. S. Peight, 159 N. C. 612, 75 S. E. 851 (1912); see Rasmussen v. Schweizer, *supra* note 22, at 216 N. W. 482: "A going corporation may buy a portion of its own stock from its stockholders, so long as its assets are in substantial excess of its liabilities and for this purpose its capital stock is not to be considered a liability."

²⁵ McCannon v. Lusk-Mitchell Newspapers, *supra* note 22, at 292 N. W. 83: "As respects power to purchase own shares, a corporation's 'surplus' represents the excess of the aggregate value of assets over the sum of the corporate liabilities and capital stock." Also Warner & Swasey Co. v. Rusterholz, 41 F. Supp. 498 (D. Minn. 1942); Western & Southern Fire Ins. Co. v. Murphey, 56 Okl. 702, 156 Pac. 885 (1916); Baird v. McDaniel Printing Co., 25 Tenn. App. 144, 153 S. W. (2d) 135 (1942).

Dean Hildebrand,²⁶ appears logical. While capital stock is not a liability in the same sense as accounts due creditors, yet the account Capital Stock does indicate an amount that is payable upon dissolution, a claim which the stockholders have against the corporation; and complete disregard of paid-in capital in determining the amount of assets a corporation will be allowed to expend in reacquiring its own stock allows no consideration of the rights of the remaining stockholders, so long as the accountants' method of treating the acquired stock is not in harmony with the judicial idea of entering treasury stock as an asset, or of not designating any account at all. The situation would not need to be extreme for the corporation to deprive effectively the remaining stockholders of a great amount of their interest in the business and at the same time remain within the law.

Still another judicial approach is that the purchase of treasury shares is valid so long as it is out of surplus.²⁷ However, this test is not different from the majority view in the rule just discussed, inasmuch as total liabilities, *i.e.*, the amounts due creditors and the claims of stockholders against the corporation as evidenced by the outstanding capital stock, includes all except surplus, which is set aside to pay dividends. Yet this rule also is inadequate so long as the court with jurisdiction calls the acquired treasury stock an asset and the accountants, attempting to follow the law and their long accepted principle, treat the stock as an asset also. For example, if a corporation with a surplus of \$10,000 acquires treasury stock in the amount of \$10,000, the asset expended will be credited that amount; and with judicial sanction a new asset account, called Treasury Stock, will be debited

²⁶ 1 HILDEBRAND, TEXAS CORPORATIONS (1942), § 79: "This latter view is the better rule since clear assets equal to the capital stock should always be kept for the creditors of the company." The Texas view is uncertain but seemingly follows the majority.

²⁷ *Robinson v. Waugermann*, 75 F. (2d) 756 (C. C. A. 5th, 1935); *In Re O'Gara & McGuire*, 259 Fed. 935 (D. C. N. J., 1919); *Richards v. Ernst Weiner Co.*, 145 App. Div. 353, 129 N. Y. Supp. 951 (1912); *Beane v. Commercial Securities Co.*, 25 Tenn. App. 254, 156 S. W. (2d) 338 (1942); *Turner v. Turner Mfg. Co.*, 184 Wis. 508, 199 N. W. 155 (1924).

with like amount; consequently the surplus account will not be touched in the recording of the purchase. The entire transaction will be valid, as the amount purchased was within the amount of surplus; and the same \$10,000 surplus could be used repeatedly.²⁸

Finally, another line of decisions declare that the legal result in a particular case depends largely upon its own facts, any statement of a rule being valid only in a general sense,²⁹ and that whether the purchase was made with intent to reduce capital stock or for resale depends upon the intention of the parties.³⁰ So long as the corporation in question remains solvent, this rule should operate justly; should the corporation subsequently become insolvent before resale and before determination of the intent, is it not too late then to look to the intent of the parties as of the time of the transaction? If the purpose in restricting the purchase by a corporation of its own stock is the protection of the remaining stockholders and creditors, their interests can better be protected by prevention than by redress after insolvency. These are only a few of the many varied rules restricting the acquisition by a corporation of its own stock.

The evils of unrestricted acquisition by a corporation of its own stock necessitate some limitation. On the other hand, the directors need a comparatively free hand in the management and

²⁸ See Hills, *Stated Capital and Treasury Shares* (1934) 57 JOUR. ACCOUNTANCY 202, 209: "If the right to purchase depends upon the existence of a surplus, the extent of that right must lessen as surplus is reduced and surplus must be reduced as that right is from time to time exercised, otherwise, the restriction would only apply to single purchases and not to the aggregate of all purchases."

See also, Blackstock, *Corporation's Power* (1935) 13 TEX. L. REV. 442, 452; Hills, *Model Corporation Act* (1934) 48 HARV. L. REV. 1334, 1373, n. 73, containing statutes. Note (1937) 85, U. OF PA. L. REV. 622, 627.

²⁹ *Sanford v. First Nat. Bank of Marysville*, 238 Fed. 298, 302 (C. C. A. 8th, 1917); *West Penn. Chem. & Mfg. Co. v. Prentice*, 236 Fed. 891, 893 (C. C. A. 3rd, 1916).

³⁰ *Borg v. International Silver Co.*, 11 F. (2d) 147 (C. C. A. 2nd, 1925); *Foster v. Plymouth Gold Min. Co.*, 29 Mont. 347, 74 Pac. 938 (1904); *San Antonio Hardware Co. v. Sanger*, 151 S. W. 1104 (1912). See also *German v. Farmers Tobacco Warehouse Co. of Danville*, 260 Ky. 249, 84 S. W. (2d) 82 (1935): "Purchase or acquisition . . . is not in itself a reduction of capital stock, but whether or not it has such effect depends on circumstances and intent with which shares are acquired."

conduct of activities so long as the policies are reasonable and for a legitimate purpose. This consideration seems to oppose the conclusion drawn by certain writers that the English rule absolutely forbidding purchases by a corporation of its own securities is the preferable one. Instead, a legislative enactment adopting sound principles of accounting in order that the true financial status of the corporation may be determinable upon the purchase of treasury stock and at the same time safeguarding the interests of the creditors and remaining stockholders,³¹ appears to be the most promising solution.

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³¹ See Hills, *Stated Capital and Treasury Shares* (1934) 57 JOUR. ACCOUNTANCY 202, 211; "Modern corporation laws have recognized that treasury stocks are the source of many abuses and have adopted corrective legislation." See also Hills, *Accounting in Corporation Law* (1937) 12 WISC. L. REV. 494, 500 as to the need for unification by legislative enactment of the law and accounting involved in treasury stock. See also note 11 *supra*.