THE PURCHASE BY A CORPORATION OF ITS OWN SHARES *

JOSE C. CAMPOS, JR.**

So much has been written on the subject of the right of a business corporation to purchase its own shares that this paper might be construed as another futile gesture towards the same end. There still remains, however, the much controverted point of how far and to what extent may a corporation be permitted to purchase its own shares. It is the purpose of this article to explore the advantages accruing from the acquisition by a corporation of its own shares as well as the abuses accompanying or motivating the exercise of such power and to suggest measures for its proper and healthy regulation. Particular emphasis is given to "effects on, and protection of creditor's rights as well as that of stockholders."

Although the English Law still denies to corporations the power to purchase its own shares, the trend in the United States is to accord such right to corporations. There is, however, a diversity of opinion as to the extent and scope of such a power. It has been urged by a few that the policy of the law as to protection of capital is not consistently carried out and that many abuses are made pos-

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* Act No. 1459, otherwise known as the Philippine Law on Private Corporations has no express provisions conferring on corporations the power to purchase its own shares except Sections 44 and 45 with respect to delinquent shares; likewise, it has no express provisions prohibiting the taking by a corporation of its own shares except Section 24, R. Act No. 337, Amending Section 120 of the Corporation law in regard to banking corporations. As to non-delinquent shares, a domestic corporation however, may purchase its own shares upon demand by dissenting stockholders when the corporation decides to "invest its funds in any other corporation or business or for any purpose other than for which it was so authorized, (Section 17½), or when it decides to "amend its articles of incorporation" (Section 18), or when the corporation decides to "sell, exchange, lease or otherwise dispose of all or substantially all of its property" (Section 28½). Under any of these circumstances, a corporation may purchase its own shares subject to the restriction that payment to the withdrawing stockholder may not be made if, after such payment, the corporate assets will not be equal to the liabilities exclusive of capital stock. Although this limitation is expressly imposed with respect to amendment of articles of incorporation, it is suggested that the same construction be read into the meaning of Sections 17½ and 28½ so as not to impair creditor's rights. The particular purpose for which a corporation may under the aforementioned sections, buy its own shares does not shed much light on whether a corporation may at all times acquire its own shares or only on certain contingencies. As the power is one generally recognized in most of the highly industrialized and progressive jurisdictions it would seem that the existence of such a power should be recognized in this jurisdiction as a concommitant element of the rise and growth of business corporations in this generation.

** LL.B., U.P. (1949); LL.M., Yale (1952); Yale Fellow, 1951-1952; Fulbright/Smith-Mundt Scholar, 1951-1952.

sible by the unrestricted use of such a power.[1] Others have branded such a power as a fruitful source of unfairness, mismanagement and corruption,[2] while others saw through the use of such power a method for secret withdrawal and distribution of the current assets of the corporation which may be needed in the business; or a means of speculating with corporate funds.[3]

NATURE AND EXTENT OF THE POWER TO PURCHASE

English Rule:

Under the English law, the purchase by a corporation of shares issued by it is held invalid unless the corporation has been expressly authorized to buy its own shares. The leading case of *Trevor v. Whitworth*[4] assigns two main reasons for denial of such a power to corporations. First, if the corporation acquires its shares with a view to selling them again, it is guilty of unauthorized speculation of its own stock, which amounts to trafficking in its own shares—an act clearly ultra vires; second, if the corporation had no intention, after such purchase, to reissue and part with the shares, the purchase amounts to an unauthorized reduction of its own capital stock and a violation of the statutory safeguards against reduction of capital. In either case, the purchase was unlawful, as not being incidental to the purposes of the corporation and as an evasion of the statutory restrictions on such reduction.[5] Shares of stock may, however be forfeited or may be surrendered to the corporation or received as a gift where no consideration is paid and asset or liability for an unpaid balance of the subscription price is released.[6]

American Rule:

The prevailing rule in the United States affirms that a corporation has the implied power to take its own shares, in the absence of statutory or charter prohibitions, provided it does so in good faith and without injury to its creditors and stockholders,[7] and provided

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[1] See Levy, Purchase by Corporation of Its Own Stock, (1930) 15 Minn. L. Rev. 1; Levy, Purchase by an English Company of Its Own Shares, (1930), 79 U. of Pa. L. Rev. 45; Glenn, Treasury Stock, (1929), 15 Va. L. Rev. 625.

[2] MORAWETZ PRIVATE CORPORATIONS, (2d ed.) p. 113.

[3] Ballentine, Questions of Policy in Drafting a Modern Corporation Law, XIX, Cal. L. Rev. (1930), 479.

[4] 12 App. Cas. 409 (1887).

[5] BALLANTINE, CORPORATIONS (1946 ed.) Sec. 256.

[6] *Kirby v. Wilkins,* (1929) 2 Ch. 444, 448; *Shaw v. Carr,* 93 Wash. 550, 161 Pac. 345.

[7] *Medical Art's Bldg. Co. v. Southern Finance & Dav. Co.,* 29 Fed. (2d) 969 (CCA 5th); *Barett v. W. A. Webster Lumber Co.* 275 Mass. 302, 175 NE 765 (1931); *O'Brien Mercantile Co. v. Bay Lake Fruit Grower's Ass'n.,* 178 Minn. 179,

further that they are not, in fact injured.[8] The underlying reason for this view seems to be the feeling on the part of American courts that the English doctrine is far too narrow and rigid and unduly ignores customary business demands.[9] Some courts construe the existence of such power as included in the express charter provisions to acquire and sell property or "chattels and effects of any kind, nature or quality." [10] Other jurisdictions find the authority as incidental to the main corporate purpose.[11]

In cases where the power was denied, the main objection to the purchase by a corporation of its own shares springs from the necessity of imposing safeguards against the depletion by the corporation of its assets and the impairment of its capital needed for the protection of its creditors.[12] As under the English rule, a corporation may, through gift or bequest, become the owner of its own shares.[13] Sometimes, treasury stock may come into existence by operation of law.[14]

DANGERS AND ABUSES IN THE UNRESTRICTED EXERCISE OF POWER

A fertile source of abuse in the exercise of this power is the existence of treasury stock. Treasury stock has been regarded as a time-honored device for marketing "low grade" securities.[15] Some

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226 NW 513 (1929); *Downs v. Jersey Central Power and Light Co.* 117 N.J. Eq. 138, 174 Atl. 887 (1934); *Lock v. Valverde Mercantile Corp.* 4 SW (2d) 662 (Tex. Civ. App. 1928); *Kennerly v. Columbia Chemical Corp.* 137 Va. 240, 119 SE 265 (1923); *Grace Securities Corp. v. Roberts,* 158 Va. 792, 164 SE 700 (1932); *Clapp v. Peterson,* 104 Ill. 26; *Dupee v. Boston Water Co.* 114 Mass. 37; *Porter v. Plymouth Gold Mining Co.* 29 Mont. 347; *City of Columbia v. Bruce,* 17 NY 507; *Adam v. New England Inv. Co.* 33 R. I. 193; *State v. Smith,* 48 Vt. 266; *San Antonio Co. v. Sanger,* 151 SW (Tex Civ. App.) 1104; *U.S. Mineral Co. v. Camden,* 106 Va. 663.

[8] See *Clapp v. Peterson,* 104 Ill. 26.

[9] See Wormser, 24 Yale Journal 176, 183.

[10] *Berger v. U.S. Steel Corp.,* 63 N.J. Eq. 809, 53 Atl. 68 (1902); *Robinson v. Beall,* 26 Ga. 17 (1858); *Dupee v. Boston Water Co.* 114 Mass. 82.

[11] *New England Trust Co. v. Abbot,* 162 Mass. 148, 38 NE 432.

[12] Warren, Safeguarding the Creditors of the Corporation, 36 Harv. L. Rev. 509, 546; Levy, op. cit. 79 U. of Pa. L. Rev. 45, 53; *Trevor v. Whitworth,* 12 App. Cas. 409. This is often explained in terms of the "trust fund" doctrine. Under this doctrine, capital was regarded as a fund to be kept intact for creditors for the satisfaction of their claims. See *Pierce v. U.S.,* 255 U.S. 398; *Lebens v. Nelson,* 148 Minn. 240; *In re Atlantic Printing Co.,* 60 F (2d) 553; *Darnell-Love Lumber v. Wiggs,* 144 Tenn. 113; *Whittaker v. Weller,* 8 Wash. (2d) 18, 111 P. (2d) 218.

[13] *Lake Superior Co. v. Drexel,* 90 NY 87 (1882); *Sherman v. Shaughnessy,* 148 Mo. App. 679, 129 SW 245 (1910); *Eggman v. Blanke,* 40 Mo. App. 318 (1890).

[14] *Condouris v. Imperial Turkish Tobacco Co.,* 22 NY 695, 5 Misc. 66 (1893).

[15] DEWING, FINANCIAL POLICY OF CORPORATIONS, 3rd ed. (1934) 434.

characterize it as the traditional method used by corporate entities for "scalawag financing," [16] to avoid legal restrictions such as that no stock can be issued below par.[17] If the issues were narrowly construed, then treasury stock could be sold below par after original stock was issued to promoters in liberal amounts as payments for services.[18] Although most statutes provide that original stock may not be issued for less than par,[19] no such restrictions attend the sale of "fully paid" stock which has returned to the corporation's treasury,[20] for interests of creditors and stockholders are presumed to be protected if the stated price is paid for the stock originally issued. No reliance is supposed to be placed on the amount the corporation realizes on those shares which subsequently return to it and consequently such stock may be sold for less than its par value.[21] So that corporation directors often, upon acquiring from among their own kin, upon organization, or in payment for "services rendered" issue stock to an amount in accordance with the high valuation placed upon the property or services.[22] Part of the stock is thereafter donated to the company and becomes non-assessable, full-paid treasury stock. The price at which it can be sold to the public becomes a matter for the honest discretion of the directors.[23]

A more recent use of treasury stock is to decrease the cost of doing business, especially where there are cumulative preferred shares, by decreasing the amount of dividends which will have to be paid in the future. The whole procedure is favored during depression as a contraction device.[24]

Treasury stock may also be availed of to perpetuate control of the enterprise without the expensive requisite of a majority of voting stock.[25] Treasury stock cannot be voted.[26] By using corporate

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[16] Nemmers, The Power of a Corporation to Purchase Its Own Stock, 1942, Wis. L. Rev. 163, 165.

[17] DEWING, *op. cit.*, p. 434.

[18] *Alling v. Ward,* 133 Ill. 264, 24 NE 551.

[19] *Donald v. American Smelting & Refining Co.,* 62 N.J. Eq. 729, 49 Atl. 771 (1900); *New Haven Trust Co. v. Gaffney,* 73 Conn. 480, 47 Atl. 760; *Scoville v. Thayer,* 105 U.S. 143, 25 L. Ed. 968 (1881); *Handley v. Stretz,* 139 U.S. 417, 35 L. Ed. 227 (1891).

[20] *Enright v. Heckaher,* 240 Fed. 863 (1917); *Ins. Press Co. v. Montauk Wire Co.,* 103 App. Div. 472, 93 NY 134 (1905).

[21] *Borg v. International Silver Co.,* (CCA 2d, 1925) 11 Fed. (2d) 143; *City Bank of Columbia v. Bruce,* 17 NY 507.

[22] See Levy, *supra,* 15 Minn. L. Rev. 1, 6.

[23] *Masher v. Sinnot,* 20 Colo. App. 454, 79 P. 742 (1905).

[24] Nemmers, supra, 1942 Wis. L. Rev. 163, 165.

[25] See Levy, supra, 15 Minn. L. Rev. 1, 6.

[26] *American Ry. Frog Co. v. Haven,* 101 Mass. 398; *Ex Parte Holmes,* 5 Cow (NY) 426; Conn. Gen. St. 1949, sec. 5181; Ark. Pope's Digest, 1937, sec. 2135(e);

funds to purchase some of the outstanding stock and retire it from the voting arena, what was before a minority in the controlling group can be converted into majority and their control may thereby be continued indefinitely.[27] A simple way of acquiring majority control is by issuing the purchased stocks to confidential friends of the directors or those sympathetic to their policies.[28] A more complicated way of accomplishing the same result is to make such purchase through a subsidiary organized for this purpose.[29] The subsidiary directors would vote the parent stock. The parent directors would vote the subsidiary stock and make their nominies the subsidiary directors. The control of the parent company would remain in the existing board of directors.[30]

Another questionable use of this power is to permit a corporation to give preference to favored shareholders—permitting them to withdraw their contributions to a venture in which they have lost their confidence.[31] The enforcement of the contract would result in securing to the shareholders whose stock the corporation purchased, a higher price for their shares than could be realized by the remaining stockholders from the assets of the concern . . . and thus the capital of the concern might be diverted from its legitimate channels and be used for the benefit of "recalcitrant or catankerous members" to the detriment of confiding shareholders.[32] In the case of banks and similar institutions where by statute an additional liability

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Cal. Comp. Law 1947, c. 1038, d. 1, T. 1, sec. 1714; Del. Rev. Code, 1935, c. 65, sec. 78; Fla. St. 1949, sec. 612.08(3); Ga. Code, New C.L. sec. 10(d); Idaho Code, T. 30, sec. 157(14); Ind. Burn's Ann. St. 1933, GCA Sec. 3(8); Ky. Rev. St., Sec. 271-135; Me. Rev. St. 1944, c. 49 sec. 45; Mich. Comp. Laws, 1929; sec. 10 as amended by L. 1947; Neb. Rev. St. 1943, sec. 21-140; Nev. Comp. St. Supp. sec. 1608 as amended by L. 1949, c. 121, sec. 3; N.J. Rev. St. 1937, sec. 14; 10-8; N. Mex. St. Ann. Comp. 1941, sec. 54-409; N.C. Gen. At. 1943, sec. 55-111; Okl. St. 1941, sec. 65 (b); Tenn. Code 1950, sec. 13-195; Wash. Remington's Rev. St. sec. 3803-28; W. Va. Code, 1931, c. 31, art. 1, sec. 39.

[27] Levy, supra, 15 Minn. L. Rev. 1, 6.

[28] *Thomas v. International Silver Co.* 72 NJ Eq. 224, 73 Atl. 883 (1907); *Elliot v. Baker*, 194 Mass. 578, 80 NE 450 (1907); *Luther v. Luther Co.* 118 Wis. 112, 94 NW 69 (1903).

[29] *Lazenberg v. International Cotton Mills Corp.*, 174 App. Div. 906, 160 NYS 1 (1916); *In re Buffalo etc., R. Co.*, 37 NYS 1048; *Oconnor v. International Silver Co.*, 68 NJ Eq, 680, 62 Atl. 408 (1905); Nemmers, *supra* . . . "where such open methods are too noticeable, a subsidiary 'blind' may be used."

[30] See Levy, *supra*, 15 Minn. L. Rev. 1, 6.

[31] *Crandall v. Lincoln*, 52 Conn. 73, 52 Am. Rep. 560 (1884); Nemmers, supra, "This is termed 'preferential liquidation' and is achieved by the corporation's buying out favored parties when ultimate purpose is to liquidate." *Grasselli Chemical Co., v. Aetna Explosive Co.*, 258 F. 66, 68 (1918).

[32] McSherry, J. in *Maryland Trust Co. v. Mechanics Bank*, 102 Md. 629, 63 Atl. 70 (1906).

over and above the paid-in capital is imposed on members, the purchase allows the favored members to escape unscathe and leaves the remaining shareholders with the burden of satisfying creditors.[33]

A more dubious use is the "conditional sale" of shares by a new corporation of uncertain future.[34] To lure otherwise unavailable investment funds out of their cubby hole, the corporation agrees to give "your money" on request during a specified period or at any time or on the happening of a specified event. The possible variations are numerous.[35] A corporation may, to entice reluctant purchasers, agree to repurchase in case they desire to back out,[36] or to give a prospective subscriber the right to return the shares to the corporation before a certain time limit without loss and thus give him a chance to reconsider his entry on the venture.[37] These sales may be made with varying degrees of publicity. All of the stock may be offered on the same terms or only some of it.[38]

The power to purchase may be used to avoid the pre-emptive rights of shareholders by use of treasury stock.[39] It has been the law in most states that new issues of stock must be offered to exist-

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[33] For a bank to use its funds in the purchase of stock might also impair or even destroy all security given by law to creditors of the bank. The law provides in effect that not the bank with all its property shall be liable for debts, but also that each stockholder in the bank to the amount of his stock, shall also be liable. But if a bank may purchase in all its stock and own it itself, then where would be the security to the creditors? See Levy, supra, 15 Minn. L. Rev. 1.

See also *Savings Bank v. Wulfukhuler*, 19 Kan. 60 (1877); *Barton v. Port Jackson*, etc. Co. 17 Barb. (NY) 449

[34] In *Paducah & M. Ry Co. v. Parks*, 86 Tenn. 554, 560, 8 SW 842, 844, the court pointed out the inherent dangers of this practice.

[35] Nemmers, *supra*, 1942 Wis. L. Rev. 163, 167.

[36] *Barrett v. King*, 181 Mass. 476, 63 NE 934; *Weiland v. Hogan*, 177 Mich. 626, 143 NW 599; *Vent v. Duluth Copper & Spice Co.*, 64 Minn. 307, 67 NW 70; *Schulte v. Boulevard Gardens Land Co.*, 164 Cal. 464, 129 Pac. 582.

[37] This potent sales feature is analogous to the "money refunded if not satisfied" and the "thirty days free trial" terms which attend the sale of other chattels, see Levy, supra, 15 Minn. L. Rev. 1, 7.

[38] Stockholders need not all be given the same rights, *Wisconsin Lumber Co. Greene et al*, 127 Iowa 350, 101 NW 742 (1904), and without knowledge by all of the existence of this option to resell, *Melocin v. Lamar Ins. Co.* 16 Wall. (US) 390, 21 L. ed. 361 (1862). In *Paducah & M. Ry. Co. v. Parks, supra*, the court had occasion to state that "conditional subscriptions to the stock of corporations are unusual and operate to defeat subscribers who become such absolutely and upon the faith that all the stock is equally bound to contribute to the hazards of the enterprise. It misleads creditors and is a fruitful source of litigation."

[39] See *Hartridge v. Rockwell*, R.M. Charleston, 260 (Ga. 1828); *Borg v. International Silver Co.* 11 F (2d) 147 (CCA 2d).

ing holders before outside public is given a chance to subscribe.[40] The purpose was to protect their ratable control of the enterprise and their rights in undivided surplus. More commonly, corporate management may desire to prevent the minority from growing and increasing their ratable control where the existing capital structure is sought to be maintained. Since, in treasury stock, shareholders have no pre-emptive rights, the management can sometimes avoid the annoying right of preemption by purchasing stock and then reissuing it to sympathetic parties.[41]

And lastly, the power may be used in aid of speculation by the corporation or by the management and for the manipulation of market prices.[42] By creating a "bull market" through extensive purchases of its own stock, a corporation sets an artificial value on its shares. Purchases made at a price above the intrinsic value of the shares would impair the finances of the company and reduce the intinsic value of the remaining shares.[43] Purchase made at a figure less than its book value, though possibly a source of profit, would be mere speculation and an unauthorized corporate activity, "economically unproductive and basically more vicious than speculation in securities of other companies." [44] Once a corporation is listed on an exchange, it is a common rule of the financial world that such a corporation must be prepared to support its stock on the market and guard it from becoming the football of professional manipulators.[45] For a corporation to refuse to support its own stock may be fatal, since depressed prices, sooner or later, affect the sales. Such

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[40] Morawetz, Pre-emptive Rights of Shareholders, 42 Harv. L. Rev. 186 (1929); Frey, Shareholders Pre-emptive Rights, 38 Yale L. J. 563 (1929); *Stokes v. Continental Trust Co.*, 186 NY 285, 78 NE 1090 (1906).

[41] *Borg v. International Silver Co.*, supra; *State v. Smith*, 48 Vt. 266; *Crosby v. Stratton*, 17 Colo. App. 212, 68 P. 130. For criticism of the rule that shareholders have no right to subscribe to treasury stock, see 36 Y.L.J. 1181.

[42] Dodd, Purchase and Redemption by a Corporation of Its Own Shares, 89 U. of Pa. Rev. 697, 706; Holt and Morris, Some Aspects of Treasury Shares, 12 Harv. Bus. Rev. 505; *In re London H. & C Exch. Bank* (1870) L. R. 5 Ch. App. 444; *Maryland Trust Co. v. Mechanics Bank*, 107 Md. 608, 63 Atl. 70 (1906).

[43] See Levy, supra, 15 Minn. L. Rev. 1, 8.

[44] See opinion of Lord Macnaghten in the case of *Trevor v. Whitworth*, 12 App. Cas. 409.

[45] Nemmers, *supra*, 1942 Wis. L. Rev. 167. The main reason in support of the proposition allowing a corporation to deal on the stock market in its own shares is the "stabilizing" result achieved by free trading. But abuses are tremendous. Dealings confuse earnings and losses in annual reports under modern statements.

stock manipulation may put the corporation into solvency or greater insolvency.[46]

RESTRICTIONS ON THE POWER TO PURCHASE

Statutory—

The dangers incident to the purchase by corporations of shares of their own issue have led to statutory regulation of the practice.[47] The question of purchase involves a matter of serious import and is one with which the public is vitally concerned.[48] Judging from the cases coming before the courts in the United States most often based on fraud or prejudice to creditors or stockholders, the bench felt there was a strong need for legislation on the matter.

The statutes heretofore enacted in various states in the U.S. deal with any one of the following restrictive limitations:

(a) Purchase by the corporation is permitted if from "surplus" of its assets over liabilities, including capital;[49]

(b) Purchase by the corporation is permitted if "out of stated capital or out of any surplus," provided it is unable or by such purchase not rendered unable to satisfy its debts and liabilities when they fall due;[50]

(c) Purchase by the corporation is permitted if "capital is not thereby impaired;" [51]

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[46] Nemmers, *supra*, 167.

[47] 6 FLETCHER, sec. 2852.

[48] Rand, J. in *Loveland & Co. v. Doernbacher Mfg. Co.*, 149 Ore. 58, 39 P (2d) 668, 676 declared that "if the right is to be recognized, therefore, it should be sanctioned by the Legislature, where all proper safeguards for the protection of creditors and stockholders may be imposed, rather than by courts." Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 Col. L. Rev. 971, 976. The growth of treasury stock is also a problem of public concern in the United States . . .

[49] Ark. Pope's Dig. 1937, sec. 2135(e); Fla. St. 1949, sec. 612.08(3); Ga. Code 1933, sec. 10(d); Tenn. Code 1938, sec. 3722; Wy. Rev. St. 1931, sec. 28-122; Minn. St. 1941, c. 301-22; S. D. Rev. Code, 1943, sec. 10-0323, out of surplus funds and by resolution of stockholders or their unanimous consent in writing; La. Rev. St. 1950, sec. 12-23, out of surplus available for dividends and only if purchase does not violate contractual right of any class of share; Ore. Comp. L. Ann. 1940, L. 1943, c. 406, see Appendix A for detailed provisions.

[50] Cal. Laws, 1947, c. 1038, div. 1, Tit. 1, sec. 1706, 1707; Kan. Gen. St. 1935, Supp. sec. 17-3004; Mont. Rev. Code, 1947, sec. 15-1801, S. B. 47; Ohio Gen. Code, sec. 8623-41 when authorized by affirmative vote of holders of ⅔ of each class of outstanding shares . . . to the extent of surplus over liabilities.

[51] Colo. St. Ann. 1935, c. 41, sec. 24; Del. Rev. Code, 1935 c. 65, sec. 78; Ind. Burn's Ann. St. 1933, GCA Sec. 3 (8); Ky. Rev. St. 1942, sec. 271.135; Mich. Comp. Laws, 1929, sec. 10(h); Neb. Rev. St. 1943, sec. 21-140; Nev. G.C.L. sec. 9; R.I. Gen. Laws, 1938, c. 16, sec. 5(h); Tenn. Code, 1938, sec. 3722(9); Wash. Pierce's Code, Sec. 4592 as amended; Md. Ann. Code, 1939, art. 23, secs. 54(7), 32(6); W. Va. Code 1931, c. 31, art. 1, sec. 39.

(d) Purchase by the corporation is permitted if "its net assets is not less than the sum of its stated capital, provided that, by so doing, its net assets would not be reduced below such sum;[52]

(e) The corporation may purchase its own shares for "non-payment of assessment or forfeiture or sale of shares" requiring publication of notice and public sale, where no outsiders bid;[53]

(f) Purchase by a corporation is permitted for a specific purpose only.[54]

In many states, treasury stock may be acquired through the necessary power in a corporation to forfeit shares for non-payment of calls or assessments.[55] This procedure, however, does not involve a purchase by the corporation. In some states there are at present no express statutory provisions on this subject.[56] Some of these latter states (North Carolina, South Carolina and Utah) have laws which contain general provisions prohibiting the dividing, with-

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[52] Mo. Rev. St. sec. 351.390; Pa. B.C.L. sec. 302 as amended by 1947 P.L. 290; Ill. Rev. St. c. 32, sec. 6, provides that a corporation shall not purchase "when its net assets are less than the sum of its stated capital, its paid-in surplus, any surplus arising from unrealized appreciation in value or revaluation of its assets and any surplus arising from the surrender to the corporation of any of its shares or when by so doing its net assets would be reduced below such sum.

[53] Ariz. Code, 1939, c. 53, sec. 211; Idaho Code, tit. 30, sec. 157(13); Me. Rev. St. 1944, c. 49, sec. 45; Mass. Gen. Laws, 1932, c. 156, sec. 20; N.D. Rev. Code, 1943, sec. 10-0345; Okl. St. 1941, sec. 126(7) & 135; Va. Code, 1950, sec. 13-98; Vt. St. 1947, sec. 5787 provides: A corporation may acquire any property . . . in payment or partial payment of a debt . . . and for such purpose permit shares of its own stock to be transferred to a trustee to hold the same in its behalf; Mont. Rev. Code, supra; Neb. Rev. St. supra; Nev. Gen. Corp. Laws, supra See Sections 44 and 45, Act No. 1459, otherwise known as Corporation Law of the Philippines.

[54] N.J. Rev. St. 1937, sec. 14-8-3 as amended by L. 193, c. 176, for retirement; Ala. Code, 1940, Tit. 10, sec. 36 requires a stockholder's meeting; N. Mex. St. Ann. Comp. 1941, sec. 54:318, for retirement; Conn. Gen. St. Revision of 1949, sec. 5181, requires approval at a stockholder's meeting.

[55] Acquired through the necessary power to forfeit shares; Cal. C. Code, 1947, sec. 2708; Kan. Gen. St. 1945, Supp. sec. 17-3405; Ny. Rev. St. sec. 271-235; La. Rev. St. 1950, sec. 12:6; Md. Flack's Ann Code, 1938, sec. 80; Mass. Gen. Laws, 1932, c. 156, sec. 19; Mich. P.L. 1931, sec. 28; Mo. P. S. 1949, sec. 351.175; Neb. R.S. 1943, sec. 21-145; N. Mex. R. St. Comp. 1941, sec. 54-312; N.Y.S.C.L. sec. 68; Pa. B.C.L. sec. 605; S. Dak. Code 1939, sec. 11.0313; Tex. R. St. 1925, art. 1336; Va. Code, 1950, sec. 13-98; W. Va. Code, 1931, c. 31, art. 1, sec. 34.

Acquired through purchase where no outsider bids: Ariz. Code, 1939, sec. 53-211, Ark. St. 1947, Sec. 64-209; Idaho Code Ann. 1949, sec. 3-157; Minn. R.S. 1945, sec. 301.17(7); Mont. R.C. 1947, sec. 15-713; Nev. G. C.L. 1925, sec. 74; N. Dak. R.C. 1943, sec. 10-0345; Okl.St. 1941, sec. 33(7); Utah Code, 1943, sec. 18-4-18; See sections 44 and 45, Act No. 1459. See also *Alling v. Wenzel,* 133 Itll. 264, 24 NE 551; *Mitchell v. Blue Star Mining Co.* 98 Wash. 191, 167 P. 130.

[56] Iowa, Mississippi, North and South Carolina, Texas, Utah, Wisconsin and New Hampshire and Wyoming.

drawing or paying any part of the capital stock to the stockholders. The courts of these states have construed these particular statutes to restrict share purchases.[57] The provisions under such general prohibitions have well been reviewed by the Utah Supreme Court in a decision which held that a corporation was prohibited from purchasing its own shares when such purchase would result in the withdrawal or payment to the shareholders of part of the capital stock.[58] In a few states, statutes on the subject impose certain liabilities or penalties to the directors.[59] A few state regulations have expressly enumerated the purpose for which the corporation may validly exercise the power to purchase its own shares, aside from the general restrictions touching "surplus" and "impairment of capital." [60] The Uniform Business Corporation Act, known as the Model Corporation Act, suggests no provision on this important matter.[61] It does not expressly declare that a purchase by the corporation of its shares which impairs capital is an unlawful distribution. In Washington, which has adopted the Uniform Business Corporation Act, it has been held that such purchases are unlawful under the "trust fund" doctrine at common law, as well as by the former general prohibition against impairment of capital.[62]

Some of the more recent statutes have restricted the general authorization for the purchase of shares to earned surplus,[63] which is the most suitable basis for withdrawals both by way of dividends and by way of share purchases.[64] A few states require the consent

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[57] *Gibbon v. Hill*, 79 F. (2d) 288; *Hansen v. California Bank* 17 Cal. App. (2d) 80, 61 P. (2d) 794; *Schulte v. Boulevard Gardens Land Co.*, 164 Cal. 464, 129 P. 582.

[58] *Pace v. Pace Bros. Co.* 91 Utah 132, 59 P. (2d) 1, 7; See *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 P. 1115.

[59] New York Penal Code, sec. 664 as amended by L. 1941, c. 838 provides: 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; (5) to apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, except as provided or permitted by law, is guilty of misdemeanor; Conn. Statutes, 1949, sec. 5181, makes the director or directors personally liable if he or they assent to the sale. See also Maryland Ann. Code, 1939, sec. 54 (7); Vermont Statutes, 1947, sec. 5787.

[60] Mo. Rev. St. 1949, sec. 351-390; Mont. Rev. St. 1947, sec. 15-801; Ohio Gen. Code, sec. 8623-41; Ky. Rev. St. sec. 271-135; La. Rev. St. 1950, sec. 12-23; Ill. Rev. St. c. 32, sec. 6; Kan. Gen. St. 1935, Supp. sec. 17-3004. See Appendix A for provisions.

[61] See Uniform Bus. Corp. Act, sec. 41 as to reduction of capital stock.

[62] *Whitttaker v. Weller*, 8 Wash. (2d) 18, 11 P(2d) 218; *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 P. 1155.

[63] BALLANTINE ON CORPORATIONS, 1946 ed. sec. 258, p. 612.

[64] *Ibid.*

of all or vote of a specific majority of the shareholders of a corporation to authorize the purchase of its shares.[65]

Judicial Construction—

However, such statutory restrictions are considered not comprehensive enough to cover all possibilities of abuses and misuse. Most of the provisions are poorly drafted.[66] To a considerable extent, the courts, by judicial construction and interpretation, have helped fill the gaps and make up for the inadequacies of the statutes, by defining the purposes for which this power of the corporation may be validly exercised. Thus, it has been held that a corporation, may, in order to prevent loss, take its shares in payment of a debt previously contracted in good faith.[67] It may repurchase its own shares in settlement of or to compromise a claim against its stockholders,[68] assuming that the debts are bonafide. Similarly, it may accept its own shares as a collateral for a debt and by enforcing its lien, may reacquire its own stock.[69] However, a purchase by an insolvent corporation from a solvent stockholder in consideration of the corporation's cancellation of the stockholder's note has been denied.[70] In all these cases, it is significant to know whether or not the debt is bona fide and otherwise uncollectible.[71]

The power may be exercised to meet the problem of internal dissension and to effect a compromise among dissenting stockholders.[72] In the small corporation, differences over policy of management are likely to be disastrous. Because of lack of a ready market for its shares and the inadvisability of dissolution, the retirement of one of the factions is easily brought about by the surrender of its shares to

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[65] *Pothier v. Reid Air Spring Co.*, 103 Conn. 380, 130 Atl. 383; Conn. St. 1939, sec. 3423; Md. Ann. Code, Art. 23, sec. 54; Ohio Gen. Code, 1940, sec. 8623041.

[66] BALLANTINE, *supra*, sec. 258, p. 610.

[67] *Ralston v. Bank of California*, 112 Cal. 208, 214 P. 476; *Coppin v. Greeneless & Ransom Co.*, 38 Ohio St. 275, 43 Am. Rep. 425; *Morgan v. Lewis*, 46 Ohio St. 1, 17 NE 558.

[68] *Draper v. Blackwell & Keith*, 138 Ala. 182; *Taylor v. Miami Exporting Co.*, 6 Ohio 176; *In re Denver Hotel Co.*, 1 Ch. 495 (1893).

[69] *City of Columbus v. Bruce*, 17 NY 597 (1858).

[70] *Fitzpatrick v. McGregor*, 133 Ga. 332, 68 SE 859 (1909).

[71] *Fitzpatrick v. McGregor, supra; State Bank v. Fox*, 3 Blatch 431; *Morgan v. Lewis*, 46 Ohio St. 1, 17 NE 558. Bona fide refers to such fact as to whether the stock was fully paid for in watered-stock sense and whether assessment is likely, See Nussbaum, *supra*, 35 Col. L. Rev. 971, 1001.

[72] *Gilchrist v. Highfield*, 140 Wis. 476, 123 NW 102 (1909); *Copper Belle Mining Co. v. Costello*, 11 Ariz. 334, 95 P. 94 (1908); *Wis. Lumber Co. v. Greene & Western Tel. Co.*, 127 Iowa 350, 101 NW 742; *Blalock v. Kernersville Co.* 110 N.C. 99, 14 SE 501.

the corporation for a consideration and the vesting of its ownership in the remaining members.[73] The creditors would ordinarily be only too willing to consent to such a change because conditions within the organization would presumably improve with unity.[74] In most of these cases, the situation may involve unanimity among all shareholders or the purchase may be effected over the opposition of dissenters, objecting either to the terms of the purchase or to the purchase in general.[75]

The encouragement of employee stock ownership by agreement of the corporation to repurchase its own shares at the original purchase price when the employee leaves the corporation is a recognized objective in the exercise of the power.[76] The general purpose is to promote employee participation in the control and profits [77] and to give the employee greater incentive to work well with the management for the success of the corporation. Under this scheme, the necessary stock is procured by the corporation from the willing sellers through purchase. The transfer to the employee is then usually made with an option in the corporation to repurchase them upon the termination of the employment, because the employee is desired as a shareholder only while he is an employee and the shares will be needed for the person who is to supplant the employee when he retires.[78] Some corporations sell stock to their employees with the provision that the corporation will repurchase at the termination of the employment contract.[79] Courts have construed cases of this type as conditional sale or a "sale or return." [80]

If more stock has been issued than the charter or articles of incorporation permit, the corporation may repurchase its own stock

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[73] Levy, *supra*, 15 Minn. L. Rev. 1, 31.

[74] Nussbaum, *supra*, 35 Col. L. Rev. 971, 1001.

[75] *Philips v. Riser*, 8 Ga. App. 634, 70 SE 79 (1911); *Calteaux v. Mueller*, 102 Wis. 525, 68 NW 1082.

[76] *Iowa Lumber Co. v. Foster*, 49 Iowa 25 (1878); *Fremont Carriage Mfg. Co. v. Thomsen*, 55 Neb. 370, 91 NW 376; *Fleitman v. John M. Stone Cotton Mills*, 186 F. 466 (CCA 5th 1911); *Harker v. Ralston Purina Co.* 45 F. (2d) 929 (CCA 7th 1930) cert. denied, 284 U.S. 619; *Dustin v. Randall Faichney Corp.* 263 Mass. 99, 160 NE 528.

[77] Nussbaum, *supra*, 35 Col. L. Rev. 971, 1001.

[78] *Topken, Loring & Schwartz Inc. v. Schwartz*, 249 NY 611, 68 NE 1118; *Lawson v. Household Finance Corp.* 147 Atl. 312.

[79] *Fleitman v. J. M. Stone Cotton Mills*, 186 F. 466 (CCA 5th 1911) cert. denied, 233 U.S. 723 (1911); *Harker v. Ralston Purina Co.* 45 F. (2d) 929 (CCA 7th 1930) cert. denied 284 U.S. 619 (1931); *Dustin v. Randall Faichney Corp.* 263 Mass. 99, 160 NE 528; *Richards v. Ernst Wiener*, 145 App. Div. 353, 129 NY Supp. 951 (1911), aff'd. 207 NY 59; *Hesse Envelope Co. v. Addison*, 166 SW 898 (Tex. Civ. App. 1914).

[80] *Williams v. Maryland Glass Corp.* 134 Md. 320, 106 Atl. 755.

in excess of the limitation fixed by the charter or articles.[81] If the corporation is experiencing difficulty and opposition from stockholders who are objecting to the corporation's effecting a desirable legitimate purpose, the corporation may purchase the stock of such objecting shareholder.[82] In the absence of unfair dealing or fraud on creditors, a corporation desiring to retire from business may do so by purchasing its shares, as in so doing, the corporation is distributing the corporate assets to the stockholders.[83]

The retention of an established policy in a closely-held corporation is another reason advanced to justify the purchase by a corporation of its own shares.[84] Purchase of a block of stock in a closely-held corporation by an outsider might create a complete change in policy, management and earning capacity for the corporation. A lifetime of hard work in developing the corporation may be jeopardized by the sale of some stock to a stranger whose only interest is the acquisition of a large dividend. To avoid such contingency a plan is adopted by which the corporation purchases the stock of the deceased or outgoing member. Usually, this scheme is carried out by policies of insurance on the lives of the large or controlling stockholders or directors to provide funds for the acquisition of their shares on their death.[85] A trustee is named as beneficiary of the policies. The agreement between the corporation and the insured stockholder provides that on the death of the latter, the proceeds of the policies will be paid by the trustee to the estate of the deceased and the stock will be transferred to the corporation. To insure fulfillment of the agreement and the procurement of the stock by the corporation, the desired number of shares to be sold to the corporation is deposited with the trustee with the rights incident to such stock. The use of a trustee and the deposit of the stock avoids dissension and a change of mind by the parties at a later date.

A situation which has frequently come before the courts is one which involves an agreement of the corporation at the time of the original subscription to repurchase the shares. Inspite of the statutory restrictions, some courts have sustained this agreement on various grounds. In fact, there has been a good deal of recognition

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[81] *Kelly v. Central Union Fire Ins. Co.*, 101 Kan. 91, 165 Pac. 806, on rehearing, 101 Kan. 363, 168 Pac. 686 (1917).

[82] *Cole v. Cole Realty Co.*, 160 Mich. 347, 135 NW 329 (1912); See also *Stott v. Orloff*, 261 Mich. 302, 246 NW 128 (1933).

[83] *Brown v. Fire Ins. Co. of Chicago*, 265 Ill. App. 393.

[84] A closely-hold corporation may be defined as a corporation in which the stock is held in a few hands, or in a few families, and which stock is not at all or only rarely dealt in by buying or selling. Words and Phrases, p. 498.

[85] *H. W. Porter & Co. v. Commissioner*, 187 F. (2d) 942.

of the validity of these agreements made as part of a subscription to shares, to repurchase the corporation's own stock within a specified time or any time the stockholder wishes to resell to the corporation.[86] Such repurchase agreements are generally part of some stock selling scheme by high pressure salesmen.[87] As has been previously pointed out in the early part of this paper, these agreements are often subject to abuse. Some courts have gone to the extent of making a judicial exception in favor of this practice under statutes restricting withdrawal of "capital stock" or forbidding purchases except out of surplus.[88] Some courts have sustained the validity of such covenants on the ground that they are conditional sales,[89] or a "sale or return" contract and that the corporation can not retain the subscription price and at the same time repudiate the illegal agreement to repurchase.[90] Even when the repurchase was made for more than the market price, these agreements have been enforced, despite resultant injury to the remaining stockholders.[91] This is even carried so far as to validate an agreement to pay a premium on repurchase and to pay interest as part of the purchase price. Such agreements, used to entice reluctant and inexperienced subscribers, should be condemned as dangerous to creditors and unfair and discriminatory as against other shareholders.[92]

The corporation usually reserved the option to redeem preferred shares at a certain redemption price in order to facilitate future financing. The option to redeem, frequently reserved to the

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[86] *Ophir Consol. Mining Co. v. Brynestone,* 143 F. 829 (CCA 7th, 1906); *Topken, Loring & Schwartz v. Schwartz,* 249 NY 206, 163 NE 735; *Norwalk v. Marcus,* 236 App. Div. 211, 256 NYS 697 (1932) aff'd. 261 NY 615, 185 NE 761.

[87] BALLANTINE, 1946 ed. sec. 259, p. 613.

[88] 4 FLETCHER, sec. 1538, sec. 2849; *Schulte v. Boulevard Gardens Land Co.,* 164 Cal. 464, 129 P. 582, where the statute prohibited withdrawal of capital stock; *Porter v. Plymouth Gold Mining Co.* 29 Mont. 347, 74 P. 938; *Oklahoma Natural Gas Corp. v. Douglas,* 170 Okl. 284, 39 P. (2d) 578, 585; *Sweeney v. United Underwriters Co.,* 29 S.D. 576, 137 NW 379; *Learmouth v. Caledonia County Corp. Ass'n.,* 109 Vt. 526, 1 Atl. (2d) 732.

[89] *Wis. Lumber Co. v. Greene & Western Tel. Co.,* 127 Iowa 350, 101 NW 742 (1904); *Chapman v. Iron Clod Rheostat Co.,* 62 N.J. Eq. 497, 41 Atl. 690 (1898); *Wolf v. Excelsior Scale Co.* 270 Pa. 547, 113 Atl. 569.

[90] *Williams v. Maryland Glass Corporation,* 134 Md. 320, 106 Atl. 755; *Ophir Consol, Min. Co. v. Brynestone* ,supra.

[91] *Furrer v. Neb. Bldg. & Investment Co.* 111 Neb. 67, 195 NW 928; *Vickey v. Niacer,* 164 Cal. 774, 129 P. 276; *Grace Securities Corp. v. Roberts,* 158 Va. 792, 164 SE 700.

[92] *In re Trichenor-Grand Co.,* 203 Fed. 720 (D.C.); *Pothier v. Reid Soring Co.,* 103 Conn. 380, 130 Atl. 383; *Hoops v. Leddy,* 119 N.J. Eq. 296, 182 Atl. 271; *Strong v. Fredrichs* (Mo. App.) 116 SW (2d) 533, 539; *Wilson v. Torchon Lace & Mercantile Co.,* 167 Mo. App. 305, 139 SW 1156; See also Levy, Purchase by a Corporation of Its Own Stock, 15 Minn. L. Rev. 1, 34.

corporation in the articles or otherwise, is not a preference for the benefit of the shareholders but a safeguard to enable the corporation to retire an obligation or a claim on the earnings, usually at a premium, when it becomes advisable for purposes of corporate financing.[93] It not infrequently happens, however, that preferred share contracts and subscription agreements provide for compulsory redemption provisions for the purpose of attracting timid purchasers.[94] Under these agreements, the corporation is under the obligation to redeem or repurchase such preferred shares on a fixed date or at the option of the shareholder, thus giving the latter a right to demand a return of his investment. It gives shareholders the opportunity of retiring from failing ventures and in so far as creditors are likely to be unaware of the existence of such strings to stock subscription, it seems somewhat fraudulent. Other shareholders may have just cause to object because their absolute subscriptions may have been made thinking the others have also contributed their shares to the enterprise without reservations.[95] It results in injury to both the creditors and shareholders by depriving the corporation of much needed capital.[96]

The California General Corporation Law declares as void redemption contracts except when under provisions for the accumulation of a sinking fund out of earnings which may be required to be applied to the purchase or redemption of redeemable shares.[97] Under the law in some jurisdictions, redemption has been permitted only but of surplus or from either capital or surplus.[98]

According to the better view, even if a positive agreement is made by the corporation to redeem preferred shares at a fixed price and date, or at the option of the holder, this does not make the holder a creditor.[99] However, a few courts have held that a com-

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[93] See BALLANTINE ON CORPORATIONS, 1946 ed. sec. 218, p. 509.

[94] *Schulte v. Boulevard Gardens Land Co.* 164 Cal. 464, 129 P. 582; *Grace Securities Corp. v. Roberts*, 158 Va. 792, 164 SE 700; 11 FLETCHER, sec. 5310.

[95] *In Burke v. Smith*, 16 Wall. 390, the U.S. Supreme Court had occasion to question the validity of such practice.

[96] *Hamlin v. Toledo, St. L. & K. C. R. Co.* 78 Fed. 670, 36 L.R.A. 826; Dodd, Purchase and Redemption by a Corporation of Its Own Shares, 89 U. of Pa. L. Rev. 697, 730-734.

[97] Cal. Civ. Code, sec. 294; Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1352.

[98] See Ark. St. sec. 64-603; Cal. Corp. 1947, sec. 1906; Del. R. Code, 1935, sec. 27; Ill. B.C.A. sec. 58; Kan. Gen. St. 1935, sec. 17-3220; Mich. P.A. 1931, sec. 37; Neb. Rev. St. 1943, sec. 21-152; N.J. R. St. 1937, sec. 14-8-3; N.Y. Stock Corp. Law, sec. 28 L. 1949, c. 805, sec. 7; Okl. St. 1941, sec. 138; Pa. B.C.L. sec. 705 as amended, 1949, sec. 12.

[99] *Com. v. John Kelly Co.*, 146 F. (2d) 406; *Vanden Bosch v. Michigan Trust Co.*, 35 F. (2d) 643; *In re Culbertson*, 54 F. (2d) 753; *Matthews v. Bradford*, 70 F.

pulsory redemption provision makes the shareholder a creditor or confers creditor's rights.[100] As a general rule, the contract to redeem is subject to the general restriction in favor of the priority of creditors and redemption and purchase may not be made where it would cause inability to meet debts and liabilities as they accrue.[101]

EFFECTS OF PURCHASE

Thus far, we have discussed the nature and extent of the power of a corporation to purchase its own shares in all its modifications and variations. Now, we shall consider the effects of such a purchase on the rights of the creditors and shareholders.

It is important to understand the financial difference between the purchase by a corporation of its own shares and the purchase by a corporation of shares issued by another independent enterprise. The latter constitute assets of possible value to creditors, while shares of the former class are in different category. Upon a surrender of its own shares, the purchase price is simply withdrawn from the business, nothing of value to creditors takes its place except what in reality is unissued share.[102]

On Creditors—

When there is no evidence as to the existence of creditors or when there are no creditors, the purchase by a corporation of its own shares will not prejudice any creditor.[103] But where there are creditors, the purchase must be made in utmost good faith. If made for the purpose of defrauding or injuring creditors or shareholders, or if it does, in fact, defraud or prejudice creditors or other shareholders, though made in good faith, it is invalid.[104] The reason advanced in favor of creditors is that the credit is extended to the corporation on the belief that the authorized stock originally issued is

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(2d) 70; *Rider v. John G. Delker & Sons Co.*, 145 Ky 634, 140 SW 1011; *Booth v. Union Fiber Co.* 142 Winn. 127, 171 NW 307.

[100] Jones, Redeemable Corporate Securities, 5 So. Calif. L. Rev. 83; Note, U. of Pa. L. Rev. 888, 893; *Best v. Oklahoma Mill Co.*, 124 Okla. 135, 253 P. 1005; *Savannah Read Estate Loan & Bldg. Co. v. Gilberbury*, 108 Ga. 281.

[101] *Mueller v. Kreauter & Co. Inc.*, 131 N.J. Eq. 475; 25 Atl. (2d) 874.

[102] BALLANTINE, supra, Sec. 256, p. 603; Morawetz, supra, (2d ed.) sec. 112; *Robinson v. Wangemann*, 75 F. (2d) 756.

[103] *Med. Arts. Bldg. Co. v. Southern Finance & Dev. Co.*, 29 F. (2d) 969; *San Antonio Hardware Co. v. Sanger*, 151 SW 1104 (Tex. Civ. App.).

[104] *Clapp v. Paterson*, 104 Ill. 26; *Columbian Bank's estate*, 147 Pa. St. 422, 23 Atl. 625; *Barrett v. Webster Lumber Co.*, 275 Mass. 302, 175 NE 765; *Thompson v. Shepherd*, 203 N.C. 310, 165 SE 791; *Taylor v. Spurway*, 91 F. (2d) 579; *Boggs v. Fleming*, 66 F. (2d) 859; *Marshall v. Fredericksburg Lumber Co.*, 162 Va. 136, 173 SE 553.

still outstanding or more accurately, that the corporate assets or their equivalent received in the sale of stock are available for the benefit and protection of creditors.[105] The restrictions and limitations imposed on this power of the corporation are aimed at imposing safeguards against the depletion by a corporation of its assets and the impairment of its capital needed for the protection of creditors.[106] Whether out of capital or surplus, the purchase of a single share involves the diminution of the corporation's assets and a corresponding impairment of the creditor's security, because from the creditor's viewpoint, treasury stock is in no sense an asset out of which to realize payment of his claim.[107] At best, it is a potentiality for the realization of assets when and if resold.[108] To this end, the statutory methods for the reduction of capital [109] generally require that the rights of creditors be safeguarded. Thus the extent of the reduction is usually limited so that it will "not reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities plus the amount of its capital stock as so reduced." [110] In some states, the consent of the stockholders plus the approval of the Secretary of State is required, to assure that the

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[105] *Hamor v. Taylor-Rice Engineering Co.*, 84 F. 392; *Clark v. E. C. Clark Machine Co.* 151 Mich. 416, 115 NW 416.

[106] This is sometimes expressed in terms of the trust fund doctrine. See *Trevor v. Whitworth*, supra; *In re Atlantic Printing Co.*, 60 F. (2d) 553 (D.C. Mass); *Cartwright v. Dickinson*, 88 Tenn. 476, 12 SW 1030, 7 L.R.A. 706; *Darnell-Love Lumber Co. v. Wiggs*, 144 Tenn. 113, 230 SW 391; *Whittaker v. Weller*, 8 Wash. (2d) 18, 111 P. 218; *Wood v. Dummer* (CC Me.) 3 Mason 308; *Pierce v. U.S.* 255 U.S. 398; Warren, Safeguarding the Creditors of the Corporation, 36 Harv. L. Rev. 509, 546; Levy, op cit. 79 U. of Pa. L. Rev. 45, 53.

[107] *In re Trichenor-Grand Co.*, 203 Fed. 720; *Stevens v. Olm Mfg. Co.*, 130 NYS 22, aff'd 131 NY 1145.

[108] Levy, supra, 14 Minn. L. Rev. 1, 9.

[109] It is generally conceded that there is no inherent or implied power to reduce capital—there must be statutory authority. See Ala. Code, 1940, Tit. 10, sec. 36; Ark. St. 1947, sec. 64-604; Cal. Civ. Code, 1947, sec. 1905; Colo. St. Ann. 1935, c. 41, sec. 49; Del. R. C. 1935, sec. 28; Fla St. 1949, sec. 612, 22; Ga. Code 1933, "N" C.L. Sec. 54; Ill. B.C.A. Sec. 60; Ind. Burn's Ann. St. 1933, sec. 25-299; Kans. G. St. 1935, Supp sec 17-3224; La. Rev. St. 1950, sec. 12; 45; Me. Rev. St. 1944, c. 49, sec. 72; Mo. Flack's Ann. Code, 1939, secs. 32 & 54; Mass. G. L. 1932, c. 156, sec. 45; Mo. Rev. St. 1949, sec. 351.195; Mont. Rev. Code. 1947, sec. 15-214; Neb. Rev. St. 1943, sec. 21-160; Nev. G.C.L. 1925, sec. 25; N. Hamp. R.L. 1942, c. 274, sec. 48; N.J. Rev St. 1937, sec 14:11-5; N. Mex. St. Ann. Comp. 1941, sec. 54-318; N.C. Gen. St. 1943, sec. 55-66; N.D. Rev. Code, 1943, Sec. 100331; Ohio G. Code, sec. 8623-39; Okla. St. 1941, sec. 143; R. I. Gen. Laws, 1938, sec. 3736; Tex. Rev. St. 1925, art. 1332; Va. Code 1950, sec. 13-206; W. Va. Code, 1931, c. 31, art, 1, sec. 13(L); Wis. St. sec. 180.07. See sec. 17, Act No. 1459.

[110] See statutes in 109, supra; See also *Signouret v. Home Ins. Co.* (CC La.) 24 Fed. 332; *Tschumi v. Hills*, 6 Kan. App. 549, 51 Pac. 619.

law will be complied. In others, public advertisement is prescribed and in a few, in order to protect shareholders, the existing division of control is sought to be preserved by requiring a ratable reduction among all members.

By purchasing shares from individual shareholders, a factual reduction in the capital can be effected without resort to the elaborate method the statutes prescribe and for purpose which, perhaps, the statute would condemn.[111] Creditors would, at least, for a time, be unaware of the change in capitalization. But whether or not the shares were actually retired at a later time, the capital would be reduced for all practical purposes—for there would be no assurance that the shares would be resold, either because the directors made no effort or because no customers could be procured at a satisfactory price.[112]

This question, then, comes up: In what way may the capital be reduced by the purchase by a corporation of its own shares? To answer this, let us assume A corporation has authorized, issued and sold for cash 1,500 shares, with par value of ₱100 per share. The balance sheet will appear thus:

A CORPORATION BALANCE SHEET
December 31, 1951

Assets		*Liabilities and Proprietorship*	
Cash	₱150,000	Capital stock	₱150,000
	₱150,000		₱150,000

If the corporation decides to purchase 200 shares of its own stock at par, the balance sheet figures may be set forth as follows:

Assets		*Liabilities and Proprietorship*	
Cash	₱130,000	Capital stock	₱150,000
Treasury stock ..	20,000		
	₱150,000		₱150,000
or			
Cash	₱130,000	Capital stock	₱150,000
		Less 200 shares treasury stock at par ...	20,000
	₱130,000		₱130,000

[111] See *Trevor v. Whitworth*, 12 App. Cas. 409 (1887).

[112] I MACHEM MODERN LAW CORPORATIONS, sec. 514; MORAWETZ, PRIVATE CORPORATIONS, 2d. ed. secs. 112-113.

The foregoing illustration will help solve the fundamental problem, namely, did the purchase of the shares represent an exchange of one form of asset (cash) for another form of asset (treasury stock), or did it represent a reduction in assets and a corresponding reduction in capital stock?

Reacquired shares are not assets.[113] Although it may be true that the corporation may sell those shares for assets which may be available for the payment of corporate debts, yet it is equally true that it may not, due to business reverses or market fluctuations, be able to resell the same. In this situation, it may rightfully be said that assets to the extent of the purchase price are gone, inasmuch as there is nothing in the corporate treasury but "a piece of paper which, as it evidences rights subordinate to the rights of creditors, is not an asset available for the payment of debts." [114] Their existence as issued shares is a pure fiction of law, a figure of speech to explain certain special rules and privileges as to their issue.[115] It no more represents a present asset than authorized but unissued shares, being merely the opportunity to acquire new assets if anyone wishes to buy the shares.[116] If the corporation becames insolvent, no such opportunity will arise and the treasury stock will represent nothing of value to the creditors.[117]

From a careful perusal of the above illustration, we see that the corporation, by purchasing its own shares, did not acquire a new asset in exchange for another asset, since reacquired shares (treasury stock) are not assets. The only consequence which said reacquired shares may bring would be a reduction of capital stock, although perhaps, as a bookkeeping device, it may be represented as a reduction of surplus.[118] Where a corporation has been a going concern and has profitably accumulated earned surplus or undivided profits, the chances are that purchase of its own stock would be made out of its earned surplus, unless by indiscriminately and negligently

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[113] An apt analysis of the character and substance of treasury shares was given by Judge Learned Hand in his opinion in *Borg v. International Silver Co.*, 11 F. (2d) 147, (CCA): "To carry shares as a liability or 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 corporation (def.) cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations."

[114] Wormser, supra, 24 Yale Law Journal, 176, 180.

[115] Glenn, Treasury Stock, 15 Va. L. Rev., 625.

[116] *Borg v. International Silver Co.*, 11 F. (2d) 146 (CCA).

[117] Glenn, supra, 15 Va. Law Review, 625.

[118] In *Wiegand & Co. v. United States*, 60 Fed. Supp. 464, the court had occasion to say: "Treasury stock should, as good accounting practice, be held as a reduction of capital."

purchasing its shares, it exposes itself to insolvency.[119] But where a corporation is in financial straits and is in need of working capital, it may find the market for its shares very lukewarm; hence, to stimulate the sale of its own shares, it engages in stock manipulation, either by direct purchase or through intermediaries. A corporation in this situation will likely have no earned surplus against which to charge purchase payments. Discounting the possibility of treating such reacquired shares as assets, the probable and ultimate result would be a reduction of the capital stock, as shown in the foregoing illustration. Hence, the security which the creditors originally had when they extended credit to the corporation is diminished by the purchase of the corporation of its own shares.[120]

Is the rule [121] henceforth enunciated only for the protection of creditors existing at the time of purchase or does it include creditors whose claims arose after the purchase? In other words, what creditors are protected by the rule regarding reduction of capital resulting from the purchase of a corporation of its own shares. There is no doubt that creditors who have advanced credit at the time of or before the stock purchase agreement was entered into are protected. Likewise, a creditor whose existence was unknown to the corporation at the making of a contract of repurchase and who did not assert his claim until after the agreement, may also be protected.[122] As to subsequent creditors, the general rule seems to be that if they entered upon that status with actual or constructive notice of the agreement to purchase they cannot later complain.[123] Some courts refuse to grant relief to subsequent creditors even without notice on the ground that they are not prejudicially affected.[124]

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[119] Even if the purchase is made out of earned surplus, it may still prejudice the remaining shareholders.

[120] The purchase in effect amounts to a withdrawal of the shareholder whose shares are purchased from membership in the corporation and a repayment of his proportionate share from the corporate assets. The members of the corporation and its capital stock are diminished. See MORAWETZ, PRIVATE CORPORATIONS (2d. ed). Vol. 1, sec. 112.

[121] That reduction of capital, resulting from purchase of the corporation's own shares, prejudices creditors.

[122] *Clapp v. Peterson,* 104 Ill. 26. In this case, a cause of action in tort arose in plaintiff's favor before the repurchase contract was entered into. Suit against the corporation was not instituted until after the agreement. The court, applying the trust fund doctrine, allowed the plaintiff to trace the property in the hands of selling stockholder.

[123] *First Trust Co. v. Ill. C.R. Co.* (CCA 8th), 256 F. 830 cert. denied, 249 U.S. 615. In this case, the notice was constructive, being stated in the mortgage which embody the repurchase agreement.

[124] *Campbell v. Grant Trust & Savings Co.,* 97 Ind. App. 169, 182 NE 267; *Rollins v. Shower Wagon & Carriage Co.,* 80 Iowa 380, 45 NW 1037.

However, the general tendency of decisions of the majority of the courts in this situation is to grant relief to creditors.[125] It is but reasonable and just that future creditors be accorded relief, who, to say the least, gave credit to the corporation on the faith that the corporation has funds with which to pay its debts and on the assumption that the corporation has done nothing which has impaired or might impair its solvency.[126] The rule, however, should be construed to exclude from the general creditors, a class of vendors of stock who have not been paid in full and who attempt to come in as general creditors.[127]

If reduction of capital by the purchase would prejudice the rights of creditors, more so would a purchase made while the corporation is insolvent or on the verge of insolvency. The question is raised as to whether solvency at the time of the contract or at the time of payment is meant. The general rule, as laid down by the leading case of *In Re Fechheimer Fishel,*[128] is that the corporation must be solvent at the time of the repurchase as well as at the time of the contract. The court discussed this point as follows: "If at the time the stockholder receives payment for his stock payment prejudices the creditors, payment cannot be enforced. If the stockholder sells his stock to a corporation which issued it, he sells at his peril and assumes the risk of the consummation of the transaction without encroachment upon the funds which belong to the corporation in trust for the payment of its creditors. The rights of the creditors cannot be defeated by the fact that at the time the transaction was entered into the seller of the stock and the officers of the corporation who purchased it were acting in good faith and supposed that the

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[125] *Lefker v. Horner,* 123 Ark. 575, 186 SW 75; *Clark v. E.C. Clark Mach. Co.,* 151 Mich. 416, 115 NW 416.

[126] In the case of *Coleman v. Tepel* (CCA 3rd) 230 Fed. 63, the court said: "We are inclined to hold . . . that the void characteristic of such a transaction as to future creditors does not depend upon fraudulent intent . . . When a stockholder, with the knowledge he has or with that with which he is charged concerning the financial condition of the corporation, engages in a transaction which results in a depletion for his advantage, of corporate assets below the subscribed capital or below existing liabilities as the law may be, and becomes a party to the solvent appearance of a business that is intended to be continued, he is bound by his act both to existing and future creditors, when its direct object or immediate consequence is the insolvency of the corporation and injury to the creditors."

To the same effect, see: *Atlanta & W. B. & C. Ass'n. v. Smith,* 141 Wis. 377, 123 NW 106; *Marvin v. Anderson,* 111 Wis. 383, 87 NW 226.

[127] Blackstock, A Corporation's Power to Purchase It Own Stock, 13 Tex. L. Rev. 442.

[128] 212 Fed. 357 (CCA 2nd, 1914).

corporation was solvent." [129] The matter of insolvency as affecting the power to purchase will be discussed in more detail under a subsequent topic.[130]

On Remaining Shareholders—

The purchase of shares by a corporation is injurious not only to the creditors but is objectionable also in that it injures shareholder's rights. The impact of this purchase on the rights of remaining shareholders is very well explained by Prof. Nussbaum as follows: [131]

> "A reduction of capital must be an all around affair; that is, where capital is to be paid off or to be cancelled as lost or unrepresented by any available assets, or where the liability for unpaid capital is to be reduced or extinguished, the same percentage should be reduced in each share. This ratable reduction would leave each shareholder the same proportionate interest and rights which he had before. Any other scheme would disturb or alter the relative positions of the members. The purchase by a corporation of its own shares withdraws part of the original capital from the venture and redistributes and changes the relative rights of the remaining members. Shareholders should have the right to insist on the preservation of all the contributed capital for the prosecution of the venture, except in case of legitimate reduction of capital which statutes authorize and which the shareholders are presumed to have made part of their contracts with the corporation. The capital subscribed is considered to be permanently devoted to the enterprise by the shareholders and it constitutes a basic business fund which must not be paid back except in entire or partial liquidation of the corporation. It might be said that when a corporation purchases its own stock, a situation is created which is analogous to the non-issuance of authorized stock. Non-issue of authorized stock is one thing, retirement of issued, another thing. Issued capital has contributed to the growth of the corporation on which the public in giving credit, by purchasing or loaning on shares or bonds or in many other ways, may rely."

A not too infrequent practice of a corporation is to effect purchases of its own shares by the use of intermediaries either through sympathetic friends or through subsidiaries. How this practice works to the detriment of the shareholders in the voting arena has been discussed in an earlier part of this paper.[132] It was there stated that by this manipulation, what was once the majority group of stockholders may easily be reduced into the minority group. Even without resorting to this practice, if the corporation succeeds in

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[129] On the same point, see *Davis v. Montana Auto Finance Co.*, 86 Mont. 500, 284 Pac. 267.

[130] See pages 25, 26 and 27.

[131] Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 Col. L. Rev. 976, 982.

[132] See page 7.

buying out opposing shareholders, an incompetent management may be able to maintain its position.

The shareholders would also be adversely affected in the field of dividends. The effects of the corporation's purchase would be felt by them sooner than the creditors would, since lack of liquidity caused by such purchases may prevent payment of dividends.[133] Often times, the articles of incorporation and even the statutes themselves, may give to the directors considerable discretion in deciding when profits shall be paid out to the shareholders as dividends. Under this situation, the stockholders are entitled to have a dividend declared only out of such part of the net earnings as can be applied to dividends consistently with a wise administration of a going concern.[134] However, it is hardly anticipated by those who buy shares or the stockholders that profits will be diverted to permit some few members to retire their capital contribution and share of the surplus from the venture, thereby postponing the payment of dividends to those remaining (as stockholders.) How a purchase of shares by a corporation affects the rights to dividends of the remaining stockholders is fully discussed by Levy,[135] as follows:

> "If the shares are purchased at a price above the actual value of the shares, the remaining members' share in the undivided surplus is impaired and money is actually being taken from the pockets of the remaining members for the benefit of the retiring shareholders. If the purchase is made at a price commensurate with the actual value of the shares, the surplus which would ordinarily be devoted to dividends, is instead tied up to effect either an indirect and unauthorized reduction in capital or else the possibility of dividends is postponed until such time as the treasury stock can be and is resold at an adequate price. And even when the price paid is less than their intrinsic value and a profit is later realized when they are reissued at a higher price, the distribution of the surplus as dividends has still been postponed."

The diminution of the number of shareholders may entail still other dangers such as proportional increase in shareholder's statutory liability where their liability is fixed beyond the amount of their subscriptions.[136] As treasury stock does not share in the profits, it may be contended that the remaining shareholders would as a result get a bigger individual share therein by way of increased dividends per share. On the other hand, their share of possible losses is increased, inasmuch as part of the working capital disappears. With

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[133] Holt and Morris, Some Aspects of Reacquired Treasury Shares, (1934) 12 Harv. Bus. Rev. 505.

[134] *Wabash Railway Co. v. Barclay*, 280 U.S. 197.

[135] Levy, supra, 15 Minn. L. Rev. 1, 26.

[136] Ibid.

this decrease in working capital, the chances are the profits will be less and therefore the proportionate share of the remaining shareholders would also be decreased.[137]

REMEDIES FOR IMPROPER SHARE PURCHASES

Of the Corporation—

Having considered the effects of the purchase by a corporation of its own shares, we now come to the question of remedies which the parties concerned may avail themselves of.

The question of the right of the corporation to rescind a consummated purchase of its own shares, or to refuse payment in pursuance of a repurchase agreement, when the purchase is illegal as contrary to statutory restrictions or as impairing the corporation's solvency, has in many instances come before the courts. If the corporation has carried out an illegal purchase out of its capital and payment has already been made, the corporation or its receiver or trustee in bankruptcy may recover from the selling shareholder, if there are creditors whose claims cannot be satisfied unless improper payments are recovered.[138] Even if the seller is honest and acts in the reasonable belief that the corporation was acting lawfully, good faith on the stockholder-vendor's part is no defense to an action by the corporation.[139] In case of improper purchases, the directors may be held liable, as well as the selling shareholder, for causing the corporation to buy its share out of capital in violation of a statute.[140] However, although a share purchase is voidable at the instance of the corporation, its receiver or trustee in bankruptcy, it does not follow that it is also voidable by the selling stockholder.[141]

The problem concerning the right of the corporation to rescind the purchase or refuse payment due to insolvency, involves various situations. If the contract of purchase is made and payment completed while the corporation is solvent, on principle, it is held that even if the insolvency thereafter ensues, the trustee in bankruptcy should not be permitted to recover the corporate payments.[142] Even,

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[137] Levy, supra, 15 Minn. L. Rev. 1, 27.

[138] *Duddy-Robinson Co. v. Taylor,* 137 Wash. 304, 204 Pac. 21; note, 47 Yale L. J. 1164, 1170; 15A FLETCHER, sec. 7419; Cal. Civ. Code, sec. 365; Ohio Code, sec. 123(b).

[139] Dodd, Purchase and Redemption by a Corporation of Its Own Shares, 89 U. of Pa. L. Rev. 697, 710.

[140] Conn. Gen. St. 1949, sec. 5181; Md., Flack's Ann. Code, 1939, sec. 54(7); New York Penal Law, sec. 664.

[141] *Darnell-Love Lumber Co. v. Wiggs,* 144 Tenn. 113, 230 SW 391; *Bellerly v. Rowland & Marwood's S. S. Co., Ltd.,* 2 Ch. 14.

[142] *Joseph v. Raff,* 82 NY App. Div. 47, Aff'd. 176 NY 611; *Tierney v. Butler,* 144 Iowa, 553.

under the English rule, the contract to purchase, althought "ultra vires", being consummated, should not be disturbed.[143] If the contract is made when the corporation is insolvent, the purchase is clearly invalid, both under the English and American views, since it jeopardizes the capital stock and diminishes the funds to which creditors would naturally look for protection of their credits.[144] Hence, the contract is unenforceable and rescindible. If the contract of purchase is made when the corporation is solvent, but the payment would cause insolvency, the transaction should be condemned and the contract regarded as unenforceable as fraudulent to creditors.[145] In *Cross v. Beguelin*,[146] the court had this to say, on this point:

> "When made, the agreement... was valid. Then, a surplus existed. After the corporation became financially embarrassed and the surplus sank to a deficit, the agreement became unenforceable as against the corporation."

If the contract of purchase is made when the corporation is solvent, but the corporation becomes insolvent before payment is made or completed, the transaction is inchoate.[147] The prevailing rule in this situation is that the claims of the selling-stockholder becomes subordinate to the claims of the creditors.[148]

Of the Creditors—

Creditors of an insolvent corporation in most cases, seek protection of their rights through a receiver or a trustee in bankruptcy.[149] The usual way of protecting creditors right, is for the receiver or trustee to resist or oppose claims of selling stockholders in suits com-

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[143] Wormser, supra, 24 Yale Law Journal, 176, 181.

[144] *Hall v. Alabama etc. Co.*, 173 Ala. 398; *Tiger Bros. v. Rogers etc. Co.*, 96 Ark. 1; *Alexander v. Relfe*, 74 Mo. 495; *Currier v. Lebanon Slate Co.*, 56 NH 266.

[145] *Atlanta Association v. Smith*, 141 Wis. 377; See also *Trevor v. Whitworth*, 12 App. Cas. 409.

[146] *Richards v. Wiener Co.*, 207 NY 59; *Loring, Topkin & Schwartz v. Schwartz*, 249 NY 206 stresses same point. 252 NY 262, affirming 236 App. Div. 349.

[147] In the case of In *Re Fechheimer Fishel*, 212 Fed. 357, (CCA 2nd, 1914) the court ruled unanimously that payment of the note given for the purchase should be postponed until after the claims of the general creditors be satisfied.

[148] BALLANTINE, CASES AND MATERIALS ON THE LAW OF CORPORATIONS, 510, 517; *Cleveland v. Jencks Mfg. Co.*, 54 R.I. 218, 171, Atl. 917; See notes on 18 Corn. Law Quarterly 489 and 42 Yale Law Journal 1128.

[149] "The receivers, representing both the creditors and the defendant, have the right to assert any defense to which creditors, in contradistinction to the defendant, are entitled," *Hamor v. Taylor Rice Engineering Corp.*, (C.C. Del. 1897) 84 Fed. 392.

menced by the latter to enforce repurchase agreements.[150] In those cases where the insolvent corporation has made full payment of the purchase price to the selling stockholders, the receiver may maintain a bill against him to recover the consideration paid.[151] In states which recognize the "trust fund" doctrine, a creditor need not limit himself to legal remedies, where he is seeking positive relief, but may resort to equitable remedies,[152] and recover even from stockholders who sold their shares in ignorance of the fact that the corporation is the purchaser.[153] In states where the foregoing doctrine has not been accorded due recognition, relief may be had on grounds of fraud or constructive fraud.[154] If immediately after the transaction, the corporation becomes insolvent or is rendered insolvent, the creditors may have the transfer set aside as a fradulent conveyance and recover such payments made by the corporation to its shareholders.[155] There is also authority for the proposition that recovery may be had against the directors of the corporation for the benefit of the creditor.[156] Where there is merely impairment of capital but the corporation is still solvent, the courts may set the conveyance

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[150] *In re International Radiator Co.* (1914) 10 Del. Ch. 358, 92 Atl. 255; *Commercial National Bank v. Burch*, 141 Ill. 519; 31 NE 420; *Columbia Bank's Estate*, 147 Pa. St. 422, 23 Atl. 625.

[151] *Crandall v. Lincoln*, 52 Conn. 73, 52 Am. Rep. 560; *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 NE 267; *Kaminsky v. Phinizy*, (CCA 5th 1931) 54 F. (2d) 16; *Lebens v. Nelson*, 148 Minn. 240, 181 NW 350.

[152] *Crandall v. Lincoln, supra.*

[153] *Crandall v. Lincoln, supra.* In this case, the court paid no consideration to the fact that the stockholder had no knowledge of the purchaser's identity.

[154] In *Hoops v. Northwesetrn Mfg. Co.*, 48 Minn. 174, 50 NW 1117, the court stated: "It is the misrepresentation of fact in stating the amount of capital to be greater than it really is, that is the true basis of the liability of the stockholder in such cases; and it follows that it is only those creditors who have relied, or who can fairly be presumed to have relied upon the professed amount of capital, in whose favor the law still recognized and enforce an equity against the holders of the "bonus stock." This case concerns a creditor's suit against holders of "bonus stock."

[155] *Corn v. Skillern*, 75 Ark. 148, 87 SW 142; *Buck v. Ross*, 68 Conn. 29, 35 Atl. 763; *Hall & Farley v. Alabama Terminal Improve Co.*, 152 Ala. 262, 44 So. 592; *Marvin v. Anderson*, 11 Wis. 387, 87 NW 226; GENN, FRAUDULENT CONVEYANCES, (rev. ed.) secs. 604, 607.

In *Fitzpatrick v. McGregor*, 133 Ga. 332, 65 SE 859, the court declared that the creditors can question the purchase "when circumstances are such as to show that the transaction was fraudulent in fact or that the corporation is insolvent or in the process or contemplation of dissolution at the time the purchase or exchange was made and also that the transaction diminished their (creditors) security for the debts due them."

[156] See Conn. Gen. St., 1949, sec. 5181; Ed. Flack's Ann. Code, 1931, sec. 54(7); New York Penal Law, sec. 664. See *Steinberg v. Velasco*, 52 Phil. 953.

aside at the instance of the creditors, unless the stock has been resold.[157]

There is conflict of authorities as to whether recovery may be had for the benefit of subsequent creditors or only for creditors existing at the time of the repurchase. A slight majority of jurisdictions seem to hold that only creditors existing at the time of the improper purchase may assail the transaction, but as has been previously pointed out,[158] a strong tendency appears to allow subsequent creditors the right of benefit or recovery also, on the ground that creditors presumably extended credit believing that the capital is unimpaired.[159]These creditors may be divided into two groups with respect to their preferential right to recover: (1) those who became such before the purchase agreement or who became such after the purchase but without notice; and (2) those who became such after the purchase with notice.[160] The claims of the first group should clearly be preferred to those of the second group since the former relied on the corporate funds as cushion.[161] Those who had notice should not be preferred even as against the selling-stockholder since actual notice is sufficient to constitute bad faith.[162]

Of the Shareholders—

The existing limitations upon the exercise of the corporation's power to purchase its own shares have dealt almost exclusively with the protection of the corporate creditors. In an earlier part of this paper, it was shown how the shareholders may be prejudiced, irrespective of injury to creditors. In most cases, though creditors suffer no injury, stockholders may be injured by shifts in voting control,[163] through giving one shareholder preference in cash assets [164] or through proportional increase in shareholder's statutory liability, or by depleting corporate funds necessary for efficient operation and creating, in some cases, fictitious appearance of success.[165] Yet courts have rarely recognized these possibilities of injury.[166] Only a few cases have held in favor of the stockholder, enjoining the corporation in the purchase of its own stock on the ground of the pre-

[157] *Erskine v. Peck*, 13 Mo. App. (1883) aff'd. 83 Mo. 467.
[158] See pages 31 and 32, supra.
[159] *Coleman v. Tepel*, 230 Fed. 63 (CCA); Notes, 20 Minn. L. Rev. 422 and 47 Yale L. Journal, 1164; 2 GLENN, FRAUDULENT CONVEYANCES, sec. 607, p. 1057.
[160] Nemmers, supra, 1942 Wis. L. Rev. 161, 174.
[161] Ibid.
[162] Ibid.
[163] See dissenting opinion in *Gipson v. Bedard*, 173 Minn. 104
[164] *Percy v. Millanden*, 3 La. 568.
[165] Levy, supra, 15 Minn. L. Rev. 1, 34.
[166] See *Price v. Pine Mt. Iron & Coal Co.*, 17 Ky. 865, 32 NW 267.

judice it may work on the remaining shareholders.[167] The case of *Hoops v. Leddy*,[168] has shown the initial step in this direction. In this case, the court phrased its decision in terms of the stockholder's rights, finding that if these agreements (to purchase its own stock) were enforced, the effect on the rights of the remaining stockholders would be:

> ". . . in equity . . . to destroy that equality which the preferred stockholders have . . . since it affords to some the right to convert their stock into cash, which is denied to others in disregard of the equitable rights of other stockholders."

This line of reasoning was also followed in the later case of *West Texas Utilities Co. v. Ellis*.[169] In some instances, the purchase was set aside by the courts at the instance of the objecting stockholder either on the ground of fraud or insolvency of the corporation.[170]

A rule parallel to the rule of "pre-emptive rights" has been adopted in some jurisdictions. This rule requires the corporation to give all stockholders an equal opportunity to dispose of a ratable proportion of their shares whenever the corporation purchases its own stock, in order to preserve the existing division of control.[171]

The problem as to whether shareholders may oppose the enforcement of repurchase agreements is not well settled. There has been a great deal of "obiter dicta" to the effect that such agreements are void not only to creditors but as to stockholders as well.[172] A few courts have held such agreements enforceable even if there is a re-

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[167] Ibid. In this case, the court said that "the contract of exchange (of note and stocks) ought not to be to the advantage of a few favored stockholders, to the injury of a great body of them . . . how muchsoever the apparent intention was to benefit all, the result of the contracts, if enforced, is disastrous to the last degree to the main body of stockholders. Under this state of the case, the contracts are at least voidable at the option of the corporation if repudiated within a reasonable time."

[168] 119 N.J. Eq. 296, 182 Atl. 271 (1936).

[169] 133 Tex. 104, 126 SW (2nd) 13 (1939). In this case, the court stated that "other stockholders could upset a contract to purchase stock from one stockholder when the result would be to harm other stockholders."

[170] *Stott v. Orloff*, 261 Mich. 302, 246 NW 128; *Commercial Nat. Bank v. Burch*, 141 Ill. 519, 31 NE 420; *Adams & Weslake Co. v. Dyette*, 5 B.D. 418, 59 NW 214; *Fall & Farley v. Henderson*, 126 Ala. 447, 28 So. 531.

[171] *Gen Invest. Co. v. American Hide & Leather Co.* 98 N.J. Eq. 326, 129 Atl. 244; *Currier v. Labanon Slate Co.*, 56 N.H. 262; *Theis v. Durr*, 125 Wis. 651, 104 NW 985; *Berger v. U.S. Steel Co.*, 63 N.J. Eq. 506, 53 Atl. 14.

[172] *Grasselli Chemical Co. v. Aetna Explosive Co., Inc.*, 258 Fed. 66, (D.C. NY); *Murphy Grocery Co. v. Skaggs*, 67 Utah 487, 248 P. 127; *White Mt. Ry. Co. v. Eastman*, 34 N.H. 124.

sultant injury to the remaining stockholders.[173] These decisions are obviously open to abuse. Under the rule of ratable purchase aforementioned, repurchase agreements are not enforceable on the theory that the privilege to resell is a violation of the equality of rights which should exist among the stockholders of a class.[174] That the courts should adopt the rule of ratable purchase as to options to resell and set aside all preferential agreements made by the corporation when stock is sold is very ably discussed by Prof. Nemmers in the following quoted arguments: [175]

> "It is believed, however, that such agreements, regardless of whether they are made with a few or all of the stockholders, should be discouraged, since they are inherently vicious. If the corporation is a financial success, the option to resell would obviously be useless; if it fails, the option may be unenforceable, either because creditors have come in or because there are stockholders objecting. The promise, therefore, is merely a snare to the investor. On the other hand, if the option is held enforceable, it must necessarily injure the remaining stockholders by the depletion of the assets of the corporation."

With respect to employee repurchase agreements [176] many courts have held them enforceable against the corporation even though there is a statute forbidding the corporation to purchase its own stock, on the theory that the original sale was under a contract for "sale or return." [177] However, such agreements cannot be enforced when the corporation is insolvent or when enforcement would prejudice creditors or stockholders.[178]

CONCLUSION

From the practical viewpoint, the purchase by a corporation of its own shares has its own advantages. Present business demands feel the need of resorting to such power for the attainment of certain objectives, which have been found to have been quite successfully accomplished in many cases, where other means have been found impractical or not feasible to achieve the desired end.

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[173] *Furrer v. Neb. Bldg. & Investment Co.*, 111 Neb. 67, 195 NW 928; *Vickey v. Kiacer*, 164 Colo. 774, 129 Pac. 276; *Grace Securities Corp. v. Roberts*, 158 Va. 792; *InWolff v. Heidritter Lumber Co.*, 112 N.J. Eq. 34, 163 Atl. 140, the court held such agreements enforceable even if there is probability of subsequent insolvency.

[174] See *Furrer v. Neb. Bldg. & Investment Co.*, supra.

[175] 1942, Wis. L. Rev. 161, 194.

[176] See page 18, supra.

[177] *Williams v. Maryland Glass Corp.* 134 Md. 320, 106 Atl. 755.

[178] *McIntyre v. Bement's Sons*, 146 Mich. 74, 109 N.W. 45.

Looked upon from the angle of management, the exercise of such a power may be used as a device to obtain any of these advantageous results: [179]

(a) Where the corporation has uninvested earned surplus remaining idle in the corporate treasury, such funds may be temporarily invested in the purchase of its own shares and if released and reissued at the propitious time, the corporation may realize profits from such speculative operations;

(b) Likewise, the dealing in its own shares may, sometimes lead to the stabilization of the market, thereby increasing the corporation's credit opportunities;

(c) Resort to such purchases will facilitate mergers or combinations of corporations whereby treasury stock is given to shareholders of merged corporations or exchanged between combined corporations, thus doing away with the necessity of increase in capital.

The foregoing advantages are strong recommendations for the recognition of the power even if the exercise by a corporation of the power to purchase may entail innumerable abuses. With the recognition which the courts and the statutes have accorded the power to purchase its own shares, what is needed, in order to restrain or regulate misuse or abuse by the corporation, is the promulgation of carefully drawn regulations prescribing the conditions under which purchases of shares may be made. The statutory regulation should be broad enough to embody the "source or basis of permissible withdrawals for payments, the status of shares after their reacquisition, the effect of later resale, reissue or retirement, the accounting practices to be followed on the purchase or reissue, and the liability of directors and shareholders for improper purchases." [180]

A curative legislation on this subject should limit purchases to those paid out of earned surplus, with a special proviso that shares may not be purchased out of paid-in stated capital or unearned surplus.[181] It should embody a clear and precise definition of earned surplus and stated capital. The nearest approach to what constitutes earned surplus is the provision of the Illinois Business Corporation Act, Annotated (1933), sec. 39, by which authority is given to a corporation to purchase its own shares "when its net assets are more than the sums of stated capital, paid-in surplus, any surplus arising from unrealized appreciation in value or revaluation of its

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[179] Nussbaum, Acquisition by a Corporation of Its Own Shares, 35 Col. L. Rev. 971, 990.

[180] BALLANTINE ON CORPORATIONS, 1946 ed., sec. 258, p. 610.

[181] The words "paid-in stated capital" and "unearned surplus" are the same as "paid surplus or capital surplus."

assets and any surplus arising from the surrender to the corporation of any of its shares, and remain so after the purchase." [182] Stated capital is the consideration received in payment for shares issued and from surplus funds capitalized by voluntary action by the Board of Directors or by the issuance of shares as a dividend.[183] It is the only margin of security for the protection of creditors and shareholders and the basis of credit of the entity. Courts should not countenance any scheme or device calculated in any manner to place any portion of the stated capital beyond the reach of creditors or prejudice shareholders. From the creditor's angle, paid-in surplus should not be treated in the same way as earned surplus and appropriated in the payment for reacquired shares, for the reason that paid-in surplus is considered as "a semi-rigid amount which acts as a margin of net worth for the protection of stated capital in a manner similar to the protection of creditors by a fixed stated capital." [184]

A curative statute, as the one suggested above, should recognize certain exceptions. For instance, purchases out of stated capital or any surplus are considered necessarily desirable. It is a generally accepted rule that shares having a distribution preference are entitled to a greater latitude than common shares. Their purchase out of stated capital is to be expected as a "normal financial operation" provided that they are treated as authorized but unissued shares.[185] Upon resale or reissue, the consideration received should be allocated to stated capital or to stated capital and paid-in surplus.[186] Likewise the purchase of shares out of any surplus may be made if the object is to collect or compromise a debt or claim. There is little opportunity for abuse here for the shares acquired will, generally, constitute a superior and more definite asset than the consideration paid the corporation. The lack of surplus should not deter the corporation from purchasing shares with the purpose of eliminating or adjusting fractional shares or to discharge obligations to shareholders who have exercised a right of dissent from a corporate action. In case of fractional shares, there will be no substantial effect on the corporate structure; in the case of a dissenting shareholder, his rights of dissent, accompanied by a further right to valuation and purchase of his shares is of fundamental importance and the purchase out of capital or surplus gives it a practical value.

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[182] Nemmers, *supra*, 1942 Wis. Law Rev. 161, 191. The indirect method of defining earned surplus is used "because of the difficulty in framing an adequate definition."

[183] Hills, The Model Corp. Act (1935) 48 Harv. L. Rev. 1334, 1335.

[184] Hills, *supra*, 1338.

[185] See U. of Newark L. Rev., Vols. 3 & 4, 1938-1939 pp. 418.

[186] *Ibid.*

How should gains and losses from the purchases of treasury stock be shown, in order to avoid deceiving creditors as well as shareholders? In line with the accepted principles, losses should be charged as deductions from earned surplus while gains should be recorded as increases in capital surplus (or unearned surplus) to prevent their being basis of dividend declaration.[187]

The accounting procedure with respect to treasury stock may be fairly summarized by quoting from Prof. Nemmers[188] as follows:

> "Purchases are to be restricted to earned surplus and are to be cumulatively shown as charged to that account on the balance sheet. Gains from purchases upon resale should be credited to capital surplus and losses charged to earned surplus."

Assuming that such statutory restrictions aforementioned be promulgated and strictly enforced, there still exist loopholes which may be exploited, under the guise of legality, to the disadvantage of the shareholders. Such measures would not avoid the squeezing of control from one group to another, or wiping out unpaid, accumulated dividends or reducing the income that is due to fixed rate, preferred shareholders, thereby increasing the funds available for unlimited dividends to common shareholders.[189]

On broad principles, a purchase by a corporation of its own shares should be subject to the following conditions:[190]

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[187] SANDERS, HATFIELD & MOORE, STATEMENT OF ACCOUNTING PRINCIPLES (1938); Report of Committees on Accounting procedure of the American Institute of Accounting, 65 J. of Accountancy 417.

[188] Purchase by a Corporation of Its Own Shares, 1942 Wis. L. Rev. 161, 188.

SCHAPIRO AND WIENSHIENK, CASES AND MATERIALS ON LAW AND ACCOUNTING, p. 330, 331, suggest the following alternatives:

"Treasury shares may be shown upon the balance sheet in either of the three ways: (a) as an asset, if resale is certain; (b) as a deduction from capital stock, if cancellation is fairly certain; (c) as a deduction from the sum of capital stock and surplus, if disposition is uncertain. Furthermore, the ownership of its own shares by a corporation organized in certain states restricts its surplus available for dividends or for additional purchases of its own shares by the cost of treasury shares purchased. This important fact should be displayed on the balance sheet either by . . . (a) a parenthetical note against earned surplus; (b) appropriation of surplus in the amount of the cost of treasury shares; (c) deducting the cost of the treasury shares from earned surplus; or (d) deducting cost of treasury shares from the sum of capital stock and all forms of surplus."

[189] The common being held by insiders or if held by outsiders the appearance of prosperity could be created by ridding the corporation of accumulated debt, Nemmers, supra, 1942 Wis. L. Rev. 161, 180.

[190] Wormser, supra, 24 Yale Law Journal 176, 188.

(a) that it be for a legitimate and proper corporate purpose;

(b) that the financial condition of the corporation will warrant such purchase without going into insolvency or financial embarrassment;

(c) that the corporation receives full consideration for its acquisition;

(d) that no undue preference or advantage is intended or given to a few favored shareholders to the disadvantage and prejudice of the others; and

(e) that the creditor and shareholder's rights are fully secured and protected.

If the rights of creditors and shareholders are thus safeguarded and if purchase be permitted from earned surplus alone as distinguished from capital stock or unearned surplus there would seem no valid ground for denying to corporations the right to acquire shares of its own stock.

To enforce the provisions of the suggested curative regulation and to deter temptations to act contrary to its positive mandates, violations or infractions should be made a misdemeanor. Experience has shown that civil redress is not sufficient to secure observance of the law. The threat of criminal prosecution, rather than actual prosecution, can be used more effectively, than compensatory damages, as shown by the anti-trust campaign in the United States.