Share Repurchases Under Modern Corporation Laws

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"The public be damned!" This picturesque expression exemplified the business philosophy of the late nineteenth century. Part of this same credo was an attitude of caveat emptor for the shareholders of corporations and a similar callousness towards company creditors. The reaction to this "rugged-individualist" position, characteristic of the "robber-barons," as some American industrial leaders were later termed when the extent of their profits through corporate manipulations became known, resulted in the passage of several repressive laws designed to protect the gullible public against the depredations of these clever operators and their skillful attorneys.

One may argue that the nation's welfare is better served by favoring the clever at the expense of public folly, and perhaps the recent centennial anniversary of the publication of Darwin's *The Origin of Species*,¹ with its doctrine of survival of the fittest, makes this an appropriate time for such an argument. Consonant with Darwin's thinking, the modern attitude toward corporation laws is a "permissive" one: corporations should in most instances be free to do as they want so long as those dealing with them have a fair opportunity to ascertain the risks involved therein, and can thus act accordingly.

If the public declines, or neglects, to read a prospectus or the fine print on the back of a stock certificate, or, perhaps, even the corporate charter, it does not seem unfair to hold them to the investment risks tacitly accepted from the constructive notice thus given. The rule of constructive notice is, after all, merely a necessary consequence of the presumption of the basically equivalent rationality of all men.

Corporation laws need not, then, bend over backwards to protect those "who have only themselves to blame." However, the choice of an individualistic, as opposed to a paternalistic, system of social organization would certainly appear to be one which should be consciously made. It is submitted that often these value judgments, the primary legislative function, have been undertaken without any appreciation of the underlying policy considerations involved, and perhaps, even devoid of any realization that basic value choices were indeed being made.

Thus it is that many corporation statutes, drafted in an era still inundated by the public reaction to corporate "excesses" bridging the turn of the century, while possessing indicia of a protective rigidity still

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¹ Darwin, The Origin of Species (1859).
allow an enormous scope for the grossest imposition upon both creditors and shareholders. Failure to take advantage of these "loopholes" seems explicable only in terms of a supererogatory conscientiousness on the part of corporate directors, or lack of imaginative legal advice.

A glaring example is provided by recent statutory provisions concerning the right of a corporation to purchase its own shares. Of the fifty-two American jurisdictions (the fifty states plus the District of Columbia and Puerto Rico), all but ten grant express statutory authorization for the exercise of the power, and even in the corporation laws of most of the latter, the existence of the privilege is made clear enough. Further, the absence of express authorization is no indication of a lack of corporation power. New York, the second largest corporation state, recognizes the right, although its clearest grant of the power is in a negative statute making it a misdemeanor for directors to purchase shares for their corporation from other than surplus, and apparently allows such purchases from any kind of surplus (hence, even one created by a mere writeup of asset value).3

The power may thus even be broader in these semi-silent jurisdictions than in those with express statutory authorization. The Massachusetts courts4 have utilized statutory sketchiness to evolve one of the broadest rules in the country as to the scope of the power, permitting general purchases to be made from capital.

Those jurisdictions which have recently5 revised their corporation laws, e.g., Alaska, Colorado, the District of Columbia, Florida, Iowa,

2. Only Alabama, Iowa, Maine, Massachusetts, Mississippi, New Jersey, New Mexico, New York, South Carolina, and Wyoming fail to grant express general permission to corporations to repurchase their own shares.

3. New York expressly makes provision only for purchases out of capital. It allows these in two instances (both of which are also permitted by the Model Act): the purchase or redemption of redeemable shares (N.Y. Stock Corp. Law § 28) and the reacquisition of shares entitled to appraisal (N.Y. Stock Corp. Law § 21). It makes the general power to repurchase clear, however, albeit negatively, from its prohibition (making directors guilty of a misdemeanor for violation) of all purchases other than from surplus. N.Y. Pen. Law § 664. Randall v. Bailey, 288 N.Y. 280, 43 N.E.2d 43 (1942), construed this "surplus" available for dividends to include an unrealized appreciation in the value of fixed assets. See also Ballantine, Corporations 541 (rev. ed. 1946).


5. The term "modern corporation statutes" can only properly be used to refer to significantly revised statutes and not to mere codifications (or reallocations) of existing law. A number of states other than those included have "new" corporation laws, but only in the latter sense. See, e.g., Ariz. Rev. Stat. Ann. tit. 10, effective Jan. 9, 1956; Hawaii Rev. Laws ch. 172 (1955), effective Mar. 18, 1957; La. Rev. Stat. tit. 12 (1950), effective Apr. 1, 1950; Nev. Rev. Stat. tit. 7, ch. 78 (1957), effective Jan. 25, 1957, all of which represent largely a recodification of pre-existing law. See note 12 infra as to the specific use herein of the term "modern corporation statute."
Maryland, North Carolina, North Dakota, Ohio, Oregon, Puerto Rico, Texas, Virginia and Wisconsin, all expressly allow a corporation to purchase its own shares. Most allow such purchases to be made, in certain instances, even out of capital.

While statutory provisions may differ, it is fair to say that none has been drawn up in ignorance of, and most have indeed been influenced by, section 5 of the so-called Model Business Corporation Act, the Committee on Corporate Laws of the American Bar Association's pro-


8. The only exception is the Florida statute, Fla. Stat. Ann. § 608.13(9)(b) (1956), which only allows purchases out of "surplus of its assets over its liabilities including capital," and the Puerto Rico law, P.R. Laws Ann. tit. 14, § 1510 (Supp. 1957), which forbids such purchases when they "would cause any impairment of the capital of the corporation." All of the others (with the exception of Virginia which allows such purchases in three of the four) at least allow purchases from capital in the four situations where such purchases are permitted by the Model Act. Two statutes even go further. Wisconsin allows acquisition from capital with 2/3 shareholder approval (of shares of equal and prior rank), where the liquidation rights of preferred shareholders are protected, provided equity insolvency (defined, Wis. Stat. Ann. § 180.02 (1957)) is not present and would not result therefrom. Wis. Stat. Ann. § 180.35 (1957). Ohio similarly allows any purchases from capital with 2/3 shareholder (all classes) approval (or a lesser percentage down to majority, if the articles so provide). Ohio Rev. Code Ann. § 1701.35(A)(9) (Page Supp. 1959). Quaere: if even the insolvency test is applicable. (Ohio Rev. Code Ann. § 1701.35(B) (Page Supp. 1959) and Committee's comment).

9. Whitney Campbell, writing in 1956 before some of the most recent statutes were passed, assessed the Model Act's influence on the preceding new statutes by the following percentages of derivation: D.C., 90%; Oregon, 95%; Texas, 85%; Virginia, 95%; Wisconsin, 90%. Campbell, The Model Business Corporation Act, 11 Bus. Law. 93 (1956). Although he claims that the Ohio statute was not used as a basis for the Model Act, the comprehensive nature of the study made by the Ohio Committee would itself indicate at least familiarity with, if not influence by, the earlier (1953) revision of the Model Act. Id. at 101. Campbell adds that although the North Carolina statute purports to be influenced by the Model Act, it is "such a poor job" that the Model Act drafters desire no credit for it. Id. at 109. (As will be suggested below, the North Carolina statute, nonetheless, possesses certain virtues over the former with regard to the provision on share repurchases.) The statutes of Alaska, Colorado and North Dakota, enacted after Campbell's article, are also clearly patterned after the Model Act.
posed paradigm for the nation’s corporation statutes. In fact, many are substantially identical to the Model Act section. Since the Model Act provision has already had such influence, and appears certain to have an even greater one on the nation’s corporation laws, it is fair to consider it as typical of the modern American law on share acquisition.

I. THE MODEL ACT

The 1957 revision of section 5 grants a corporation the right to purchase and deal in its shares out of “unreserved and unrestricted

10. The following jurisdictions allow the same purchases from capital as does the Model Act: Alaska, District of Columbia, Maryland, North Carolina, North Dakota, Ohio, Oregon, Texas, Wisconsin, and except for repurchase of fractional shares (which are forbidden to be issued—Va. Code Ann. § 13.1-21 (1950)), Virginia. Likewise, Alaska, Maryland, North Carolina, North Dakota, Ohio, Oregon, Texas, Virginia and Wisconsin, in effect, allow the use of any surplus for purchases of shares. (The District of Columbia is an exception, permitting only the use of earned surplus for all but the special Model Act capital purchases.) Similarly, all, except Alaska, which by following the earlier (1953) Model Act provision seems to permit extraordinary capital purchases to be made even though the insolvency test is not met, at least forbid such purchases if equity insolvency is present or would result from such repurchases.


12. The recent statutes of Alaska, the District of Columbia, Maryland, North Dakota, Oregon, Texas, Virginia and Wisconsin have all been significantly influenced by the Model Act. Henceforth, when the term “modern corporation statutes” is used herein, it is meant to refer to the laws of these jurisdictions, unless the context otherwise indicates.


Although the Florida, Ohio and Puerto Rican statutes all qualify temporarily as modern revisions, they appear to have been less influenced by the Model Act, at least in their share repurchase provisions, and are, therefore, not herein castigated with the characterization “modern corporation statutes” unless the context indicates otherwise.

13. The A.B.A. Model Bus. Corp. Act § 5 (rev. 1953), as subsequently revised in 1957, provides:

A corporation shall have the right to purchase, take, receive or otherwise acquire, hold, own, pledge, transfer or otherwise dispose of its own shares, but purchases of its own shares, whether direct or indirect, shall be made only to the extent of unreserved and unrestricted earned surplus available therefor, and, if the articles of incorporation so permit or with the affirmative vote of the holders of at least two-thirds of all shares entitled to vote thereon, to the extent of unreserved and unrestricted capital surplus available therefor.
earned surplus," or if the certificate so provides,\textsuperscript{14} or two-thirds of the shareholders having voting rights approve, out of its "unreserved and unrestricted capital surplus"\textsuperscript{15} as well.

To the extent that earned surplus or capital surplus is used as the measure of the corporation's right to purchase its own shares, such surplus shall be restricted so long as such shares are held as treasury shares, and upon the disposition or cancellation of any such shares the restriction shall be removed pro tanto.

Notwithstanding the foregoing limitation, a corporation may purchase or otherwise acquire its own shares for the purpose of:

(a) Eliminating fractional shares.
(b) Collecting or compromising indebtedness to the corporation.
(c) Paying dissenting shareholders entitled to payment for their shares under the provisions of this Act.
(d) Effecting, subject to the other provisions of this Act, the retirement of its redeemable shares by redemption or by purchase at not to exceed the redemption price.

No purchase of or payment for its own shares shall be made at a time when the corporation is insolvent or when such purchase or payment would make it insolvent.

This 1957 revision of § 5 was apparently designed to make it clearer that purchases from capital were to be forbidden when equity insolvency was present or would result, and, also, presumably to meet the problem raised by contracts to repurchase.

14. As most certificates will undoubtedly provide, since it is the custom of lawyers to make corporate powers as broad as the law permits. See Pantzer & O'Neil, The Drafting of Corporate Charters and By-Laws 29-32 (1951).

15. Although these terms are nowhere expressly defined in the Model Act, the purpose is to prevent the re-use of such surplus for any other repurchases until the shares are cancelled. See A.B.A. Model Bus. Corp. Act § 5, comment (rev. 1953). Strange as it may seem, the surplus might otherwise be used over and over again to make share purchases. This is true because reacquired shares may reduce pro tanto the liability side of the balance sheet, hence leaving the surplus constant. Nemmers, The Power of a Corporation to Purchase Its Own Stock, 17 Wis. L. Rev. 161, 184 n.129 (1942), illustrates this deceptive accounting practice used by some corporations with a simplified balance sheet:

Before purchase:

\begin{tabular}{c|c|c}
 \hline
 Cash & $100,000 & Capital Stock \$ 90,000 \\
 & $100,000 & Surplus 10,000 \\
 \hline
 \end{tabular}

\begin{tabular}{c|c|c}
 \hline
 & $100,000 \\
 \hline
\end{tabular}

After purchase of $10,000 stock at par with cash:

\begin{tabular}{c|c|c}
 \hline
 Cash & $ 90,000 & Capital Stock \$ 80,000 \\
 & $90,000 & Surplus 10,000 \\
 \hline
 \end{tabular}

\begin{tabular}{c|c|c}
 \hline
 & $ 90,000 \\
 \hline
\end{tabular}

If the stock is bought below par there will even be an increase in the surplus if this accounting method is permitted! The Model Act restriction is clearly wise, therefore. However, it should be noted that the same result as that shown above can still be achieved under the Model Act, by simply retiring the stock purchased, instead of keeping it in the "treasury." The corporate asset fund may thus, like sand, trickle out of the hands of creditors into the pockets of the shareholders. See also Ballantine, op. cit. supra note 3, at 627-31 (especially at 631). Presumably, under the Model Act, since acquisition of treasury shares does not reduce stated capital (§§ 2(b), 2(j)), although the asset side is reduced (treasury shares are not an asset, § 2(i)), the balance sheet, until formal action was taken to retire the treasury shares, would be as follows after such a repurchase:
In addition, under the Model Act, a corporation may also purchase or redeem its shares out of "stated capital" to eliminate fractional shares.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>Stated Capital:</td>
</tr>
<tr>
<td></td>
<td>Outstanding shares $80,000</td>
</tr>
<tr>
<td></td>
<td>Treasury Shares 10,000</td>
</tr>
<tr>
<td></td>
<td>Surplus (Unrestricted) 10,000</td>
</tr>
<tr>
<td></td>
<td>Surplus (Restricted) 10,000</td>
</tr>
<tr>
<td></td>
<td>$90,000</td>
</tr>
</tbody>
</table>

Any other share repurchase would presumably not be permitted, since effectively out of stated capital, sed quaeret. It is clear, however, that a $10,000 share repurchase would normally reduce surplus available for dividends and additional share repurchases by $20,000. (Only, however, until retirement of the shares, after which the (unrestricted) surplus would again be $10,000. Quaeret: if all of this would be capital surplus?) Such a "doubling [of] the adverse effect" is criticized in Hackney, The Financial Provisions of the Model Business Corporation Act, 70 Harv. L. Rev. 1357, 1393 (1957). Hackney suggests that the treasury shares should be carried as an asset. It is submitted that the practice of carrying treasury shares as an asset is so misleading to the uninitiated that it should never be permitted for any reason, however cogent. It is further submitted that the double adverse effect is desirable in a statutory framework which gives so little other protection to creditors and shareholders from improvident distributions.

If the treasury shares are not retired but ultimately resold at other than their stated capital figure, additional problems as to the appropriate surplus account which should be credited are raised. See Amory and Hardee, Materials On Accounting 323-30 (2d ed. 1953). The Model Act and modern corporation statutes leave these problems largely unsolved.

16. The Model Act definitions of "stated capital," "surplus," "earned surplus" and "capital surplus" are a distinct improvement over the previously uncertain usages, and in line with modern accounting principles. (Compare, however, A.I.A. Research Bull. 39). Section 2 defines them as follows:

(j) "Stated capital" means, at any particular time, the sum of (1) the par value of all shares of the corporation having a par value that have been issued, (2) the amount of the consideration received by the corporation for all shares of the corporation without par value that have been issued, except such part of the consideration therefor as may have been allocated to capital surplus in a manner permitted by law, and (3) such amounts not included in clauses (1) and (2) of this paragraph as have been transferred to stated capital of the corporation, whether upon the issue of shares as a share dividend or otherwise, minus all reductions from such sum as have been effected in a manner permitted by law. Irrespective of the manner or designation thereof by the laws under which a foreign corporation is organized, the stated capital of a foreign corporation shall be determined on the same basis and in the same manner as the stated capital of a domestic corporation, for the purpose of computing fees, franchise taxes and other charges imposed by this Act.

(k) "Surplus" means the excess of the net assets of a corporation over its stated capital.

(l) "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus.

(m) "Capital surplus" means the entire surplus of a corporation other than its earned surplus.

"Net assets" is defined as:

"(1) 'Net assets' means the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation."

See generally, Ballantine, op. cit. supra note 3, at 478-81.

A corporation's "stated capital," or "capital" in its correct usage, is, therefore, merely the "answer" obtained by applying a general mathematical formula (the legal "definition") to the individual corporate variables. This "answer" tells the corporation the amount of
collect or compromise an indebtedness owed to the corporation, pay dissenting shareholders the appraisal value of their shares, or retire (subject to sections 60 and 61,¹⁷ and provided no more than the "redemption price"—"call price"—is paid)¹⁸ its redeemable shares.

No purchase may be made, however, which would result in insolvency in the equity (as opposed to bankruptcy) sense.¹⁰

assets which public policy dictates it must keep on hand (or wisely invested) for adequate protection of its creditors' and shareholders' rights. Ballantine, op. cit. supra note 3, at 478, calls capital a "limitation." He states that its primary purpose is "to maintain a margin of net assets in the business over bare solvency or the equivalence of assets and liabilities as a basis of financial responsibility to creditors, a substitute for the personal liability of shareholders. The protection of shareholders, preferred and common, is also contemplated." Id. at 570.

The terms "capital" and "stated capital" are used herein in this sense of a legally prescribed mathematical limitation on corporate distributions.


¹⁷ These sections provide:

§ 60. No redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such redemption or purchase would render it insolvent, or which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

§ 61. When redeemable shares of a corporation are redeemed or purchased by the corporation, the redemption or purchase shall effect a cancellation of such shares, and a statement of cancellation shall be filed as provided in this section. Thereupon such shares shall be restored to the status of authorized but unissued shares, unless the articles of incorporation provide that such shares when redeemed or purchased shall not be reissued, in which case the filing of the statement of cancellation shall constitute an amendment to the articles of incorporation and shall reduce the number of shares of the class so cancelled which the corporation is authorized to issue by the number of shares so cancelled.


¹⁸ See note 13 supra.

¹⁹ "Insolvent" is defined in Model Act § 2(a) as follows: "'Insolvent' means inability of a corporation to pay its debts as they become due in the usual course of its business." All modern statutes have such insolvency limitations on share repurchases. In addition, the modern corporation statutes of Maryland, North Carolina and Texas also forbid purchases when bankruptcy insolvency is present or would result.

Justice Douglas, in Finn v. Meighan, 325 U.S. 300, 303 (1945), thus distinguished equity from bankruptcy insolvency: "'[I]nsolvency in the equity sense has always meant an inability of the debtor to pay his debts as they mature. Under the Bankruptcy Act it means an insufficiency of assets at a fair valuation to pay the debts."
It is submitted that this provision and its statutory adherents are of the most "rugged-individualist" kind, constituting a danger to unwitting creditors and shareholders, and therefore legislated, perhaps, without full appreciation of potential consequences, for a corporation's right to purchase its own shares "involves a matter of serious import, and is one with which the public is vitally concerned."\textsuperscript{120}

Since the Model Act is the archetype of modern corporation law provisions on the subject, its potential dangers warrant analysis in order that states proposing to enact similar provisions may at least legislate with complete cognizance of the social implications involved.

II. REASONS FOR SHARE REPURCHASES

It is initially appropriate however to inquire into the reasons for which a corporation, or, more accurately, its board of directors, may desire the power to purchase its own shares. An English court which led English law into an unqualified prohibition of such purchases, found no justifiable reason for the exercise of such a power:

What was the reason which induced the company in the present case to purchase its shares? If it was that they might sell them again, this would be a trafficking in the shares, and clearly unauthorized. If it was to retain them, this would be to my mind an indirect method of reducing the capital of the company. The only suggestion of another motive (and it seems to me to be a suggestion unsupported by proof) is that this was intended to be a family company, and that the directors wanted to keep the shares as much as possible in the hands of those who were partners, or who were interested in the old firm, or of those persons whom the directors thought they would like to be amongst this small number of shareholders. . . . No doubt if certain shareholders are disposed to hamper the proceedings of the company, and are willing to sell their shares, they may be bought out; but this must be done by persons, existing shareholders, or others, who can be induced to purchase the shares, and not out of the funds of the company.\textsuperscript{21}

Nevertheless, boards of directors of American corporations have often found it desirable to purchase shares for various reasons, and have usually been supported by the courts.\textsuperscript{22}


\textsuperscript{21} Trevor v. Whitworth, [1887] 12 A.C. 409, 416-17.

A. Share Repurchases: First Category

1. Redeemable Stock

Redeemable stock is usually regarded by businessmen as a debt which they are anxious to retire as soon as possible, so that corporate profits may go unrestrictedly to the common stockholders, the real owners of the corporation. Speedy redemption of such securities, with the consequent freedom from recurrent "interest payments" in the form of guaranteed (cumulative) dividends is therefore as desirable as the retirement of any other corporate obligation. Often, however, redemption of a whole class of stock at one time is not economically feasible. Gradual purchases will accomplish the same end, and when made under favorable market conditions, result in an over-all saving to the corporation. Purchases of redeemable shares have often been undertaken by corporations, therefore, and judicially approved.

2. Shareholder Indebtedness to a Corporation

Sometimes a person indebted to a corporation is also a shareholder. In the absence of other assets with which to pay the obligation, it is certainly better for the corporation to take back stock in settlement of its claim than to obtain an unenforceable judgment for a higher amount. This may be so even though the market value of the shares received may be less than the amount of the debt owed, since the corporation receives the additional benefit of a release of its dividend obligations to the debtor—shareholder. Hence corporations have accepted their shares in compromise of indebtedness, and have been upheld by the courts for doing so.

3. Dissenting Stockholders

Dissenting shareholders have at times, unfortunately, been motivated by the "blackmail value" of their stock votes in their adamant refusal
to approve management proposals for significant corporate changes. Here, too, corporations are anxious to buy out recalcitrants, at a fair price, and are often actually compelled to do so under so-called appraisal statutes. A corporation’s right to pay such dissenting stockholders the appraisal value of their shares is thus desirable and has met with judicial approbation.\textsuperscript{27}

4. Fractional Shares

Often as a result of a stock dividend shareholders become entitled to fractional shares. For example, if the stock dividend is to be one share for each 100 held, a holder of only 50 shares is entitled to only $\frac{1}{2}$ share, and even a holder of 1050 shares will also end up with a fractional share for that odd 50 he holds. While the problem could be solved by giving all shareholders an option to take cash in lieu of fractional shares, this might result in undesirable tax consequences to all shareholders (even to non-recipients of fractional shares).\textsuperscript{28} Consequently, issuance of such fractional shares is frequently indicated. They are, however, a nuisance, since doubt exists as to their actual status. Do they have half a vote at stockholders’ meetings? Are they entitled to half a share of dividends? Such questions remain unsolved. While it may be desirable for a corporation to dispose of fractional shares by purchase and resale as units or by retirement, case law on the power is, however, almost nonexistent.\textsuperscript{29}

All of the above four reasons for a corporation’s repurchase of its shares fall into one class. Under the Model Act, and its “progeny,”

\textsuperscript{27} Sections 71 and 74 of the Model Act recognize the right of dissenting shareholders to the appraisal value of their stock on mergers, consolidations and sales or exchanges (other than in the usual course of business). New York is probably the most generous in according such rights to dissidents from a number of corporate decisions. N.Y. Stock Corp. Law § 21 lists the various sections of the New York statute giving rise to an appraisal right. See also Ballantine, op. cit. supra note 3, at 606.

\textsuperscript{28} Under Int. Rev. Code of 1954, § 305(b)(2), if an election is granted to “any” shareholder to take cash in lieu of the stock, the distribution becomes immediately taxable under § 301. “Scrip” is a possible statutory alternative for issuance of such fractional shares. See Va. Code Ann. § 13.1-21 (1950), which authorizes this as a substitute for the forbidden fractional shares.

these purchases may even be made out of capital.\textsuperscript{30} They are also, in this respect, extraordinary, since the Model Act generally only permits share purchases from earned, and under certain circumstances, capital surplus. The drafters of the Model Act apparently felt that these four categories of purchases were important enough, and sufficiently innocuous, to merit special treatment.

B. Share Repurchases: Second Category

Of course, other reasons may dictate a corporation’s repurchase of its shares. Shareholder subscription agreements sometimes require such repurchases to be made at the election of the shareholder.\textsuperscript{31} A corporation may utilize these agreements to attract initial capital which might otherwise be difficult to obtain, and yet is necessary to get the enterprise under way, or to advertise as a “selling point” the name of the shareholder, thus stimulating other share subscriptions and credit extensions.

Furthermore, many modern business corporations, realizing that employee incentive is fostered by giving loyal workers a share of the profits, have devised plans for transferring stock to employees.\textsuperscript{32} Since a corporation must have shares available for distribution, it needs the power to purchase them for that purpose. Because the basic reason for share distributions to employees disappears once the latter leave the corporation’s employ, employee stock plans usually require the employee to surrender his shares upon termination of his corporate connection. The employing corporation must naturally be able to repurchase such shares to make effective the employee’s obligation to surrender them when their purpose of securing his faithful service has ceased.

1. Close Corporations

Repurchase agreements are even more important for close corporations.\textsuperscript{33} In the typical close corporation the shareholders are also the


\textsuperscript{31} Ballantine, op. cit. supra note 3, at 613 n.45; Stevens, op. cit. supra note 26, at 283-86.

\textsuperscript{32} Nemmers, supra note 15, at 164; Dodd, Purchase and Redemption by a Corporation of Its Own Shares: the Substantive Law, 89 U. Pa. L. Rev. 697, 715-17 (1941); Ballantine, op. cit. supra note 3, at 606. See also McQuillan v. National Cash Register Co., 112 F.2d 877 (4th Cir. 1940), and Kerbs v. California E. Airways, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952), illustrating the use of such incentive plans and their problems. As to the ever-increasing utilization of such employee-stock purchase plans, and the reasons therefor, see the recent announcement of the inauguration of such a plan by Mercil & Co., Inc., in N.Y. Times, April 29, 1959, p. 49, col. 2.

\textsuperscript{33} See generally, 2 O’Neal, The Close Corporation 1-80 (1958), as to these “buy-sell” agreements. For a carefully drafted restrictive stock transfer agreement not too advantageous to the selling shareholder, see Lawson v. Household Fin. Corp., 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930).
most important employees. The corporate form of business has been chosen solely for its advantage of limited liability: the participants regard themselves as partners, and desire to have the same control over the entry of new "partners" as exists in legal partnerships. Such corporations, therefore, in addition to the typical "veto" powers given shareholders (to render the corporation as much like a partnership as possible), usually also have stock repurchase agreements so that the remaining "partners" may determine who shall be their new "partner" when one of their number dies or decides to terminate his participation. Shareholder agreements in a close corporation often obligate the corporation, rather than the individual stockholders, to repurchase the departing (or departed) shareholder's interest, rendering imperative a corporate power to repurchase in order to effectuate these agreements.

2. Public Issue Corporations

In the public issue corporation, management may find it more expedient to buy out recalcitrant minority shareholders (whether or not they hold redeemable stock or are entitled to appraisal rights) than to face their constant obstructionism. Such purchases may also be desirable, from management's point of view, to prevent shares from falling into the hands of syndicates desirous of taking over the corporation merely to "milk" it (either through liquidation or improvident dividend payments at the expense of capital improvement), and incidentally, at least, to protect their own jobs as directors and officers from the inevitable dismissal which a change in majority share ownership augurs. Prudent share purchases may therefore be used (for good or ill) as a way of manipulating corporate control.

A second reason for such repurchases is as part of a plan for acquisition of the assets of another business, to be "paid for" in stock of the purchasing corporation.

Directors of a public issue corporation may also want to purchase its shares on behalf of the corporation to "make a market" for a new

34. See O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 Harv. L. Rev. 773, 789, 794 (1952). But compare Snee & Cusack, Principles and Practice of Estate Planning 216-17 (1959), suggesting possible tax disadvantages from an agreement whereunder the corporation, rather than the remaining shareholders, is to reacquire the shares of a retiring member.

35. E.g., purchase by Axton-Fisher of enough of its own common stock, thus preventing control from falling into the hands of Transamerica Corp., would have prevented the "milking" of the corporation which took place in Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). See also the situation posed in Baker & Cary, Cases on Corporations 569 (3d ed. Abr. 1959).

36. See Nemmers, The Power of a Corporation To Purchase Its Own Stock, 17 Wis. L. Rev. 161, 166 (1942):

"Once a corporation's stock is listed on an exchange, it is a common rule of the financial
stock or bond issue which might otherwise sell poorly. Purchases of securities for the purpose of creating an artificial market are forbidden under the Federal Securities laws, and the regulations promulgated thereunder by the SEC. "Stabilizing" purchases, or those designed to prevent the market for a security from falling, although restricted, are not forbidden. Share purchases to aid marketability desirable from the corporations' perspective, are, therefore, legally recognized, albeit to a limited extent.

world that such corporation must be prepared to support its stock on the market and guard it from becoming the football of professional manipulators. For a corporation to refuse to support its own stock may be fatal, since depressed prices on the stock exchange, even artificially depressed prices, sooner or later affect sales and credit standings. The argument for permitting a corporation to deal on the exchanges in its own stock thus is the same as that which supports the existence of the exchange itself, the 'stabilizing' result achieved by freetrading."

Nemmers adds, however: "But abuses are unlimited. Dealings confuse earnings and losses in annual reports under many modern statements which do not distinguish between an operating statement of ordinary business transactions and a general profit and loss statement. Such manipulations may throw a corporation into insolvency or deeper into insolvency. It is true that the majority American rule is hemmed in by the usual fraud and fiduciary qualifications, but these may be small comfort when the burden of showing violations is on the plaintiff stockholder, especially where the corporation is large and the stockholder small." Id. at 167. See also Berle & Means, The Modern Corporation and Private Property 175-76 (1932): "On the other hand, there is something to be said for permitting a corporation to buy shares of its own stock, especially where the market machinery has temporarily broken down. During the panic of November, 1929, many corporations were urgently asked to use their surplus funds for such purchase. The incidental effect was to shift the asset values of the remaining outstanding shares. But the motive was to provide market purchases for shares of stock, and to keep running the mechanism of the public market. It is difficult to regard this process as anything other than a legitimate use; it was, in fact, the only available means of safeguarding a decent market appraisal for the bulk of the stockholders." This theory that "support of the market" purchases are proper is criticized in Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 Col. L. Rev. 971, 986-90 (1935).

37. See S.E.C. Rules X-10B-6, X-10B-7, 17 C.F.R. §§ 240.10b-6, 240.10b-7 (Supp. 1958). The effectiveness of these rules is circumscribed by the statutes under whose authority they were promulgated, and which they are designed to implement. See Nussbaum, supra note 36, at 1004-05, as to the inadequacy of these statutes. As to other federal statutes, see Dodd, supra note 32, at 717-19.

38. However, note the possible danger to directors, at the hands of minority shareholders, even if they do not violate any S.E.C. regulations. Stella v. Kaiser-Frazer, 82 F. Supp. 301 (S.D.N.Y. 1948).

39. Federal law does, however, make "trafficking" in its own shares extremely onerous for a corporation. Although, as indicated, the obstacles to share repurchases by ordinary public issue corporations (i.e., those subject to the Securities Act of 1933, and the Securities Exchange Act of 1934, but not to such specialized statutes as, e.g., the Public Utility Holding Company Act of 1935) are not particularly significant, sales of treasury stock by such corporations are subject to the same requirements as would be an original
The Model Act and most modern corporate statutes, recognizing a corporation's desire to make purchases for these and other unanticipated reasons, grant a blanket right to purchase from earned surplus and, where the Articles so provide, or two-thirds of the voting shareholders consent, from surplus however created. Such an over-all grant, rather than a specification of the exact circumstances under which the power may be exercised, is undoubtedly a recognition of the limitations of human foreseeability of the sundry situations when the board of directors may legitimately desire to purchase their corporation's shares. Is the grant perhaps too broad, too general, so as to be a potential danger to creditors and shareholders of the corporation, and thereby quite beyond the actual intent of the legislatures enacting such statutes? It is submitted that such is the case, even though in this second category, purchases may only be made from surplus.

Since in the Model Act and its offspring the grant to purchase from issue of new stock. See Securities Act of 1933, § 2(1), 48 Stat. 74, 15 U.S.C. § 776(1) (1958). Thus, such a corporation will be required under section 5 of the 1933 Act to file a registration statement or, what is regarded by the practicing bar as equally burdensome, the "notification" required for "small issues," 17 C.F.R. § 230.255 (Supp. 1958), and comply with the other requirements which are part of this process, 17 C.F.R. §§ 230.400-493 (Supp. 1958), if it desires to sell any of the reacquired shares.

40. See note 16 supra for definition.

41. Section 5 of the Model Act permits purchases to be made under such circumstances from "capital surplus." It is clear from the definition of "net assets," "stated capital," "surplus," "earned surplus," and "capital surplus" (see note 16 supra), that all net assets which are not earned surplus constitute capital surplus, since it is merely the balance remaining after debts, stated capital and earned surplus have been subtracted from total assets. Capital surplus is, therefore, a "catch-all." It includes reduction surplus (§ 64), a surplus which may be created directly by act of the shareholders (§ 63 or §§ 53 and 54) through simply voting to reduce stated capital, or indirectly, by act of the board of directors in voting to retire repurchased shares (§ 62), automatically by voting to acquire redeemable shares (§ 61), and through allocation by the directors of no-par consideration on issue to capital surplus (§ 19). It is to be observed that the size of the capital of the corporation is, therefore, completely at the disposal of its shareholders and directors. The actual asset fund on which the creditors may call for satisfaction of the debts owed them may well vary in direct proportion to the size of this stated capital. At most they are given constructive notice of their lessened protection through the annual report of § 118(g) (as to the amount which has not been allocated to capital surplus with regard to no-par shares) and the filing requirements of §§ 63 and 57 (for §§ 53 and 54 changes) where the stated capital has been reduced directly, and §§ 61 and 62 where the stated capital has been reduced indirectly (through share repurchases). Presumably such capital surplus may be created through a reappraisal of the value of the corporation's assets in a time of economic inflation (if the assets figure increases, while the subtractors of debts and earned surplus remain constant, manifestly the balance, capital surplus will be a higher figure). One sentence in the articles of incorporation will make all these freed assets available for share repurchases. Since most corporations will probably insert this sentence, the ultimate effect is (if the technicalities are complied with) to make virtually all assets available for share purchases, until the corporation is no longer able to pay its debts as they mature.
surplus is a general one, and enumerated instances concern only purchases from capital, a consideration of these dangers divides itself most appropriately into a discussion based on the sources from which share repurchases are to be allowed. It is probably safe to conclude initially, however, from the many instances in which American corporations have exercised the power in the past, with judicial approbation and without shockingly harmful effects upon creditors and shareholders, that the English rule of absolute disqualification should be rejected. Generally speaking, share purchases by a corporation should be allowed. Clearly the corporation has an "interest" in making such purchases, at least in the situations delineated above. The only question then becomes one of qualifications upon the exercise of the right. This problem, as is the case with most legal investigations, reduces itself to an evaluation of competing interests (a choice of harmful vs. beneficial effects to each group) in a trichotomy which also includes creditors and shareholders of the corporation.

III. PURCHASES FROM CAPITAL

Even if the concept of capital as a "trust fund" for the creditors of a corporation be rejected, it is still well-established that one of the basic reasons behind the requirement is to provide for sufficient corporate assets to discharge corporate obligations. A subsidiary function of capital is the protection of senior shareholders of a corporation by granting them some assurance that there will be sufficient corporate assets available to discharge their liquidation preferences. The requirement also inures ultimately to the benefit of all shareholders, since it is at least a limited guarantee against improvident distributions of their contributions and resultant financial collapse of the corporation.

Although the introduction of no-par stock and "liberal" allowance of

42. For an explanation and criticism of this theory, see Stevens, Corporations 870-75, 906 (1949).

43. Ballantine, Corporations 571-72 (rev. ed. 1946). A similar function is performed to a very limited extent by § 51 of the Model Act which requires that a minimum consideration of $1000 be paid in for the shares before a corporation may enjoy de jure existence.


45. Although the Model Act (1953 rev.) required that at least 75% of the consideration received for no-par shares be allocated to stated capital (§ 19), that requirement was deleted by the 1957 Addendum. Except for preference shares for which an amount equal to any liquidation preference must be allocated to stated capital, the Model Act would now permit allocation of "any portion" of the consideration received for no-par shares to capital surplus, thus making it available for share repurchases. The Model Act as amended, therefore, makes capital (where no-par shares have been issued) almost as illusory a protection for creditors and shareholders as it is under the New Jersey statute, which allows a similar allocation, N.J. Rev. Stat. §§ 14:8-6-8 (1937), and makes the surplus thus created available even for dividends, N.J. Rev. Stat. §§ 14:8-19 (1937). Coupled with the other techniques of reducing stated capital (see note 89 infra), it is so easy to build up capital
charter amendments reducing capital\textsuperscript{46} have created serious restrictions upon the \textit{effectiveness} of the device, the salutary \textit{purpose} of the requirement remains unaltered.\textsuperscript{47}

It is obvious that whatever reduces the sum of liquid (or liquifiable) corporate assets reduces the fund on which creditors and shareholders may rely for satisfaction of their respective debts or equity claims. Under modern statutes not all of the money contribution of shareholders need be assigned to this fund.\textsuperscript{48} Even that which is so assigned is subject to fluctuation in realizable value not only as the general economy goes up and down, but as the preferences of the public for the product dealt in by the corporation change.\textsuperscript{49} It is therefore clear that capital sets at most a minimal requirement for the full satisfaction of obligations to creditors and shareholders. No matter how defined, any "impairment of capital," or diminution of this fund, is undesirable from the point of surplus by diverting capital, that only restrictions on "utilization" of that surplus can be relied upon to give even minimal protection to creditors and shareholders. Such limitation on the utilization of capital surplus is obviously a simpler task than a complete revamping of the financial provisions of the Act. One way of preserving the asset fund at a level high enough to afford the protection which capital itself was traditionally designed to perform, is at least to limit share repurchases to actually earned surplus, thereby plugging at least one hole in the dike gouged out by the easy techniques of converting capital into a spurious (capital) surplus.

\textsuperscript{46} As to the ease of reducing stated capital under the Model Act and its offspring, see note 89 infra.

\textsuperscript{47} To the extent that the consideration received by the corporation for no-par shares may be diverted to surplus directly, or stated capital reduced at the will of the shareholders, the protection afforded to creditors from capital requirements becomes more and more an illusory safeguard. At least constructive notice of such diversions from the capital to surplus accounts must be given. Therefore, although the capital requirements under the Act may not do much to make the position of creditors and senior shareholders enviable, that position would be worsened still by a complete abandonment of the stated capital requirement which provides at least a temporary sandbag levee holding the corporate assets in bounds. Certainly, if dangers are great this can be no argument that they should be greater. However, it supplies a convincing argument that general share repurchases should be forbidden from capital surplus, i.e., that such repurchases be made only from actually earned surplus.

\textsuperscript{48} E.g., through use of no-par stock. See notes 45 and 47 supra. Accountants may object to the use of the term "fund" to describe legal capital, since, of course, technically, legal capital is not a fund. However, the term is an appropriate shorthand expression (much like saying that dividends are paid "out of" surplus) for the effect of legal capital on the asset position of the corporation: as an item on the righthand side of the balance sheet (unless it reveals an impairment, itself a red flag to creditors and stockholders) it must be counterbalanced by the items on the left or asset side, necessitating maintenance of a sufficient asset pot.

\textsuperscript{49} A corporation, of course, may invest its assets, even those represented by stated capital in goods and products of fluctuating value. E.g., public taste for the furniture which a furniture store has invested in, will, of course, alter the value of those assets. See Ballantine, op. cit. supra note 43, at 533.
view of creditors and all shareholders (except those who receive preferential treatment in the disposition of this "capital").

For this reason most jurisdictions (except where statutes expressly authorize such purchases, and then only under the special conditions therein prescribed) forbid share repurchases by a corporation out of capital. A notable exception is Massachusetts, which, lacking a specific statute on the subject, permits purchases even out of capital, provided such purchases are made "in good faith and without prejudice to the rights of creditors or other shareholders." It would seem well nigh impossible to find a situation in which some prejudice would not result from such purchases, at least to creditors, since such purchases obviously result in a subtraction from the fund on which they may call for payment of what is due them. Perhaps in acknowledgment of this fact the Model Act, and statutes based on it, only allow such purchases from capital in the four extraordinary situations which constitute the first category of purchases discussed above. In only two of these four cases, however, can it be really conceded that the potential disadvantages to creditors are outweighed by other considerations.

A. Redeemable Shares

The Model Act's approval of the purchase of redeemable shares out of capital is qualified by the limitation contained in section 60, which provides:

No redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such redemption or purchase would render it insolvent, or which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

The effect of this provision is to protect those senior shareholders who have a liquidation preference in a manner analogous to that protection extended creditors by the bankruptcy insolvency test. It must be conceded that this limitation also affords some protection to creditors. Since the limitation is in terms of the total assets required to satisfy merely the liquidation preference of shareholders, and hence the fund is perhaps not as large as it would be were purchases or calls which reduced assets below liabilities interdicted (it must be recalled that only equity and not bankruptcy insolvency is forbidden), it is true that the asset fund thus frozen would be available to the creditors in priority

52. See note 13 supra.
53. See note 17 supra.
to the preference shareholders for whom it was ostensibly set up.\textsuperscript{54} An additional protection to both creditors and shareholders (whose shares are not purchased) is the proviso in section 5 that the purchase price may not exceed the price at which the shares may be called.

These provisions are the most restrictive on share repurchases found in the Model Act. Yet, although such purchases may not cause insolvency, they \textit{do} reduce capital, and are, as a result, disadvantageous to creditors.\textsuperscript{55} Even if a redeemable shareholder be regarded as a species of corporate creditor,\textsuperscript{56} is there any justification for favoring him in preference to the other, and the only legally recognized, creditors, which is the real effect of such a grant of power? A corporation may be a long way on the road to failure without actually being insolvent (in either the equity or bankruptcy sense). The Model Act allows the directors to "bail out" favored shareholders with no loss, and perhaps even a profit (since the shares may be redeemed at call price when in a failing corporation the market price, and hence cost to the shareholder, may be considerably less),\textsuperscript{57} at the possible expense of creditors\textsuperscript{58} and junior stockholders. For adequate protection of the latter, purchase of re-

\textsuperscript{54} On a bankruptcy distribution or reorganization, even unsecured creditors take priority over preferred shareholders. See 3 Collier, Bankruptcy 1787, 6 id. at 2858 (14th ed. 1956).

\textsuperscript{55} Redeemable shares are automatically retired by reacquisition (Model Act § 61), thus automatically reducing stated capital where such reacquisitions are made, as the Model Act authorizes them to be, from capital. It is to be observed that under the Model Act such capital reduction is accomplished by the board of directors without the necessity for shareholder approval, and has the effect of leaving the corporate surplus unimpaired and hence available for dividend distribution or other share repurchases. See, however, N.C. Gen. Stat. §§ 55-52(g) (Supp. 1959), under which redeemable shares are not automatically cancelled by reacquisition.

\textsuperscript{56} Which, of course, legally he is not. See cases cited note 23 supra, and Ballantine, op. cit. supra note 43, at 503.

\textsuperscript{57} Only one modern statute even attempts to prevent this fruitful opportunity for insider profits. Md. Ann. Code art. 23, § 32(b)(1) (1957), with certain exceptions, forbids redemption at more than the net asset value attributable to the shares being redeemed when this is below the call price. The object is to prevent the scooping off of dwindling assets for favored shareholders. If, as is probable, the market price will roughly approximate this asset position, some safeguard against the speculation envisaged is provided.

\textsuperscript{58} Even if it be conceded that creditors are given adequate protection by a bankruptcy insolvency restriction on share repurchases (e.g., Md. Ann. Code art. 23, § 32(c) (1957), N.C. Gen. Stat. § 55-52(e)(2) (Supp. 1959), and Tex. Bus. Corp. Act art. 2.03F (1953)), and the welfare of junior shareholders may be disregarded as part of the risks of common stock ownership, it should be observed that the Model Act does not even protect all of the senior shareholders. If there are not enough assets to bail out all of them, the directors are at liberty to discriminate as they choose. Thus the Model Act provision does not even protect all of those whom it was designated to favor. It will perhaps come as a surprise to many people that the New York Stock Exchange has been more of a leader in corporate morality than the state legislatures have been. Since 1899, corporations wishing to have
their securities traded on that exchange have had to execute a "Listing Agreement," which currently provides with regard to redemption: "The Corporation will not select any of its securities listed on the Exchange for redemption otherwise than by lot or pro rata, and will not set a redemption date earlier than fifteen days after the date corporate action is taken to authorize the redemption." New York Stock Exchange Company Manual § 1(9), at A-24.

Although not expressly required to do so by the Listing Agreement, the Exchange also expects the same equitable procedures to be used where purchases by a corporation are to be made of any of its shares, redeemable or not. See New York Stock Exchange Company Manual A-10, 24, 179-80.

Such limits on redemption and purchase of redeemable shares would seem essential additions to any provision designed to give effective protection to the rights of redeemable shareholders. Yet the Model Act omits them. Of the modern corporation acts, only North Carolina attempts to insure that repurchases and redemptions will be equitable to the entire class whose shares are being reacquired by a provision requiring pro rata purchase where general share purchases are not approved by the shareholders or do not fall under one of the exceptions of the section. N.C. Gen. Stat. §§ 55-52 (Supp. 1959). On the other hand, only Texas provides for ratable or lot selection of redeemable shares. Tex. Bus. Corp. Act art. 4.03 (1953). Additional protection is given redeemable stockholders by such statutes as those of Oregon (Ore. Rev. Stat. § 57.390 (1959)); Wisconsin (Wis. Stat. Ann. § 180.385(1)(b) (1957)), and North Carolina (N.C. Gen. Stat. §§ 55-52(e)(3), (4), (f) (Supp. 1959)).

Clearly, no redemption of the shares of a corporation, even when the holders whose shares are to be redeemed are fairly chosen, should be permitted to reduce the remaining assets below those required to meet the liquidation preferences of those unredeemed (or of those shareholders prior in right to them). This is what these statutes are designed to forbid. A limitation forbidding reacquisitions except from earned surplus would accomplish the same results more simply. The real effectiveness of such a restriction, however, depends on the ease with which capital surplus may be converted by corporate fiat into earned surplus. Although as pointed out, note 16 supra, the Model Act definitions of "stated capital," "surplus," "earned surplus" etc., are an improvement in clarity, a grave danger is created by Model Act § 64, which allows directors to convert capital surplus into earned surplus. (See Model Act § 2(k),(l),(m), comment.) The greater the ease with which this transfer may be accomplished, the less meaningful does a distinction between earned and capital surplus become in terms of legal consequences. Therefore, unless more stringent limits on transfers of capital to earned surplus are applied, a more appropriate definition of earned surplus for purposes of limiting share repurchases would be similar to the share repurchase section of the wiser grandfather of modern corporation laws, Ill. Ann. Stat. ch. 32, § 157.6 (Smith-Hurd 1954), with the more modern "capital surplus" substituted for "paid-in" surplus:

"A corporation shall have power to purchase, take, receive, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares, provided that it shall not purchase, either directly or indirectly, its own shares 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 surrender to the corporation of any of its shares, or when by so doing its net assets would be reduced below such sum."


As to surplus under modern corporation laws, see generally Hackney, The Financial Provisions of the Model Business Corporation Act, 70 Harv. L. Rev. 1357, 1358-92 (1957). Hackney suggests that the Model Act provisions are not without ambiguity. He also sug-
deemable shares should be allowed only out of earned surplus, and treated as any other share purchase from such source.\textsuperscript{69}

B. Compromising Corporate Claims

The second extraordinary situation in which the Model Act permits share repurchases out of capital is for the purpose of “collecting or

gests that there is some ambiguity as to whether the four extraordinary purchases permitted under the Act may be made from stated capital even where earned surplus is also available. \textit{Id.} at 1398. It seems clear that the drafter intended that such purchases be permitted. Hackney approves the exceptional treatment accorded by the Model Act to purchases “(1) and (4), and perhaps (2),” i.e., elimination of fractional shares, redemption of redeemable shares, and possibly, collecting or compromising indebtedness. \textit{Id.} at 1399. He further suggests other purchases which should be permitted from capital, but are not, namely, to permit a conversion privilege, and a stock exchange as part of a recapitalization (presumably, such as in \textit{Shanik v. White Sewing Mach. Corp.}, 25 Del. Ch. 154, 15 A.2d 169 (Sup. Ct. 1940)). \textit{Ibid.} The author, for reasons indicated in the body of this paper, feels that exception (1) is unnecessary, disapproves of exception (4), would allow exception (3), which Hackney would forbid (at 1399), and approves of exception (2) with suggested limitations.

As for the exercise of conversion privileges, the author feels that, if no undesirable features appear, they will be construed as not being “purchases,” and, hence, not restricted by the Model Act. With regard to any feature of a recapitalization, the Model Act is, if anything, overgenerous through its permissible ease of capital reduction, and hence no additional exceptions are needed. Certainly a Shanik-type of recapitalization, i.e., creation of a prior preference preferred, which, without their vote, the old preferred shareholders are given the choice of taking in exchange for their old shares on which large arrearages have accrued—or else (the typical totalitarian political choice), should not be fostered.

Hackney also points out that the Model Act, through excluding treasury shares from net assets (§ 2(i)), and at the same time restricting surplus used for their repurchase (§ 5), doubles the “adverse effect caused by the purchase.” Hackney, supra at 1393. He means that only half as many shares can be repurchased with the same amount of surplus as would otherwise be the case, unless the repurchased shares are retired. Rather than a defect, this seems to be a bright spot in the otherwise dim picture created by the Act.

59. Under § 61 of the Model Act and most modern corporation statutes, reacquisition of redeemable shares by either purchase or redemption has the effect of automatically retiring the shares so reacquired. Thus an automatic reduction in stated capital results. If such reacquisitions may be made from capital or general surplus, the effect is to leave the surplus intact. See note 15 supra. While reacquisitions from earned surplus will likewise leave the total surplus intact, the requirement will result in converting that portion of it used for the reacquisitions into capital surplus, thus, if purchases generally are similarly restricted to earned surplus, making it unavailable for dividends (Model Act § 40(a)) or additional share reacquisitions, with their consequent dilution of the total asset fund. Requiring that reacquisitions of redeemable shares be made from earned surplus has the effect, therefore, of keeping the actual asset fund at a higher level. This affords protection to creditors and shareholders continuing on in the corporation. These latter do not care by what name their protective fund is called, or by what “technicalities” it is secured. The effect is the thing, and such a “technicality” as requiring reacquisition to be from earned surplus effectively keeps their fund at a higher level than would otherwise be the case. They are, therefore, safeguarded pro tanto. See, however, note 58 supra; note 97 infra; Ballantine, op. cit. supra note 43, at 612; Stevens, op. cit. supra note 42, at 282.
compromising indebtedness to the corporation." A corporation is normally allowed to accept its shares in compromise of a claim which it holds, even though this works a technical impairment of capital. As Stevens states:

Even though such a transaction results in the cancellation of a debt due the corporation in return for the shares, it is a bona fide business transaction, and, because it saves the corporation from greater loss, cannot be complained of by creditors.

Normally such compromises, even if they necessitate small payments by the corporation to the debtor where the value of the shares are in excess of the indebtedness, are unexceptionable. Abuses are, however, possible. Loans to corporate insiders (directors and officers, and in the New York statute, shareholders) are often forbidden. Yet, "sales" to such insiders are not. Insiders might well make transfers to their friends of valuable corporate assets on credit, later "compromising" such debts for corporate stock on which they had placed an inflated value. The danger of such abuses is slight in the face of traditional rules of fiduciary obligation, and manifestly the harm to creditors (unless the "compromises" include large payments by the corporation) from the impairment of capital is offset by the diminution in the corporation's dividend obligations. Nevertheless, for the adequate protection of creditors such compromises should be expressly required to be bona fide, as has been

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60. See 6A Fletcher, Private Corporations § 2857 (rev. ed. 1950); Ballantine, op. cit. supra note 43, at 606.

61. Stevens, op. cit. supra note 42, at 278.

62. E.g., Model Act § 42.

63. N.Y. Stock Corp. Law § 59.

64. See, e.g., the high standard of fiduciary duty set in Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955). Quaere: the effect of the maxim "expressio unius est exclusio alterius" on such a statute as § 43 of the Model Act, which expressly enumerates a number of grounds of directorial liability, but omits the one suggested.

65. Another interesting problem, and another one not dealt with specifically by the Model Act, is that of gifts of shares to a corporation. Normally, such reacquisitions would be an unexpected boon to the corporation, and obviously of no harm to either shareholders or creditors. They would, therefore, if anything, be even less objectionable than receiving shares in compromise of an indebtedness. However, a gift of shares to a corporation may be a way of escaping statutory liability to creditors (including employee creditors), and, consequently, undesirable from the latter's point of view. For example, New York makes shareholders individually liable for wages owing to corporate employees. N.Y. Stock Corp. Law § 71. A donation (or bequest) of shares to the corporation would provide an effective means of escape from such statutory liability. Although such statutes rendering shareholders individually liable for corporate obligations are on the wane, Ballantine, op. cit. supra note 43, at 820-23, gifts to a corporation of its shares might still be used in a situation possible under most corporation statutes today. The general rule is that creditors may compel shareholders to pay any unpaid balance due on their share subscriptions. Ballantine, op. cit. supra note 43, at 782. If shareholders are at liberty to surrender their shares to their corporation, thus terminating their liability, a major loophole for fraud on creditors...
C. Dissenting Stockholders

Creditors are technically harmed, through capital impairment, when capital is used to pay off dissenting shareholders who exercise their appraisal right. They may be harmed even more if a minority shareholder is allowed to "hold up" a corporation about to enter into a merger, consolidation, or advantageous sale of assets.

Furthermore, since, as a practical matter, dissenters are necessarily less than one-third of the shareholders, and usually an insignificant number, the capital impairment is unlikely to be great. For these reasons, and because it would be anomalous for the majority shareholders to object to such payments, even though out of capital, they should be allowed.

As with the compromise provision, however, the Model Act verbiage leaves much to be desired. It provides that a corporation may purchase its shares for the purpose of "paying dissenting shareholders entitled to payment for their shares under the provisions of this Act." Presumably the provisions referred to are section 71 (Rights of Dissenting Shareholders in Mergers or Consolidations) and section 74 (Rights of Dissenting Shareholders Upon Sale or Exchange of Assets), which require the

is provided. A guarantee against such abuse might be provided by a provision like that of Md. Ann. Code art. 23, § 32(d) (1957): "No acquisition by any corporation by gift, bequest or purchase of shares of its own stock which have not been fully paid shall release, or be made the basis of a release of, the liability of the holders thereof unless the assets of the corporation remaining immediately after such release shall be not less than the debts of the corporation plus the amount of its stated capital." Even such innocuous appearing reacquisitions should thus at least be required to be bona fide. Note also the possible use of donated shares as part of a scheme for issuance of discount shares. Ballantine, op. cit. supra note 43, at 800. As to the general rule allowing a corporation to accept a gift or bequest of its shares, see 6A Fletcher, op. cit. supra note 60, at 396-97.

68. A further safeguard is to restrict the permission solely to acceptance of shares in compromise of indebtedness, without granting the implied power (through use of the word "purchase") to make settlements which may require cash payments to the debtors on such compromises. Certainly any such payments should be forbidden from capital. Reacquisitions in discharge of indebtedness, of course, also raise the same problems as the acceptance of gifts of its shares by a corporation. See note 65 supra.
69. See Ballantine, op. cit. supra note 43, at 606, as to the recognition of such reacquisitions.
70. For example, the Model Act only allows appraisal rights in the case of mergers or consolidations (§ 71) or sales or exchanges of assets other than in the regular course of business (§ 74). These, however, require two-thirds shareholder approval (§ 67 as to mergers and consolidations; § 73(b) as to sale or exchange of assets). Dissenters must of necessity constitute less than one-third of the shareholders.
corporation to pay the dissenting shareholder "the fair value" of his shares. Perhaps the intent was to forbid a corporation to pay more than the fair value when repurchasing such shares. Still, on its plain meaning, the paragraph only indicates whose shares may be bought, and not the amount which may be paid for them. Manifestly, the interests of creditors and remaining shareholders demand that no bonus be paid from capital to dissidents. Adequate protection requires the proviso that repurchases may be made at no more than fair value, or, at the very least, that directors make such purchases in good faith.72

It might be argued that such explicit dictates that share repurchases be made in good faith are unnecessary in view of the developing, and ever more stringent, common-law rules of fiduciary duty.73 The argument would be forceful were it not for the Model Act's express provision for director liability with respect to corporate purchases of shares "contrary to the provisions of this Act."74 Since neither the actions warned of here or in the compromise of claims exception would directly contravene the provisions of the Act, courts might well refuse to find liability for acts not expressly proscribed. In this judicial determination that common law rules of fiduciary obligation were supplanted by the unqualified statutory grant, they would be supported by the maxim of statutory construction, expressum facit cessare tacitum. At any rate it is undesirable that statutes should engender ambiguities.

D. Fractional Shares

The remaining Model Act exception to repurchase only out of surplus is to retire fractional shares, which normally would result only from stock dividends. Such dividends mean a transfer of surplus to capital, and hence an improvement of the creditor's position.75 A slight reduction in this bonus capital to retire fractional shares should thus give the creditor no grounds for complaint. Although such fractional shares are usually the result of such dividends, the Model Act does not require that they be. There would appear to be nothing to prevent a corporation from issuing all of its stock in fractional shares (Model Act sections 14 and 22), should it choose to do so, and thus effectively circumvent any restrictions on share repurchases. Unless the issuance of fractional shares is limited, therefore, their repurchase should only be allowed out of earned surplus. Furthermore, even if fractional shares are limited to those resulting from stock dividends, there would appear to be no valid reason for permitting

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73. See note 64 supra.
74. Model Act § 43(b).
75. See Ballantine, op. cit. supra note 43, at 481-83. But note that even here abuses are possible, since allocation of surplus to capital does not always take place.
them to be purchased out of capital, since no prudent corporation would declare a stock dividend which completely exhausted its surplus.\footnote{1}

Another defect in the Model Act with regard to share acquisitions in this entire extraordinary class of capital purchases is its failure to require the exhaustion of surplus for such repurchases before the capital account may be eaten into. Clearly, if a corporation has a surplus, it should be required to utilize it completely before dipping into its capital, no matter how cogent may be the reasons for share reacquisitions.

Thus, of the four Model Act exceptions to its general rule that share repurchases may only be made from surplus, in only two, buying out dissenting stockholders at the appraisal value of their stock and accepting shares in compromise of an indebtedness, are the harmful effects upon creditors and other shareholders sufficiently outweighed to justify allowance of such purchases from the capital fund. And even these exceptions are so poorly drafted as to make them inadequate. Of course, these defects would not be objectionable had they not passed from the merely theoretical into the positive law of so many jurisdictions.\footnote{27}

IV. PURCHASES FROM SURPLUS

Contrary to the English rule, most American jurisdictions, apart from express statutory grant, permit a corporation to repurchase its shares where only surplus is used.\footnote{78} The Model Act and many modern corpora-

\footnote{76. There would seem to be no good reason for the issuance of fractional shares of stock anyhow as opposed to scrip or rights to purchase. Certificates are not normally issued for such partial shares, and although scrip is recognized, fractional shares are not traded on the New York Stock Exchange. A corporation may give a holder entitled to a fractional share the choice of putting up sufficient money to buy a full share or of having his fractional interest "sold," i.e., paired off with another such partial share to give a full share to a holder who chooses to exercise his right, with cash payment from the latter to the one who elects not to make up the difference. Since in a going concern, the fractional share problem may always be handled in this manner, or by retirement from surplus, there would seem to be no need either for the issuance of fractional share certificates, or for their repurchase from capital.}

\footnote{77. See note 10 supra.}

\footnote{78. Ballantine, op. cit. supra note 43, at 604; Stevens, op. cit. supra note 42, at 275. See 6A Fletcher, op. cit. supra note 60, at 364: "Subject to severe criticism the majority of the American courts have taken the view that a solvent corporation may lawfully purchase and hold its own stock without express authority, in the absence of express restrictions, provided it acts in good faith and without prejudice to the rights of creditors, and has a surplus with which to make the purchase." The "severe criticism" refers to the unheeded warnings of law review authors and text writers. Ballantine, op. cit. supra note 43, at 609, lists six dangers from such dealings by a corporation in its own shares. Only one significant legal writer, my late predecessor as professor of corporation law at Fordham, I. Maurice Wormser, has defended the majority American rule. Wormser, The Power of a Corporation To Acquire Its Own Stock, 24 Yale L.J. 177 (1915). A bibliography of materials on the subject will be found in Baker & Cary, op. cit. supra note 35, at 1053.}
tion statutes allow purchases out of "earned surplus" for any purpose, and without limitation, except that these purchases may not be made when insolvency (in the equity sense) is present, or would ensue from such purchases.

The Model Act also permits (with only the same insolvency restriction) such purchases from any type of surplus if two-thirds of the voting shareholders approve, or if the articles of incorporation so permit. Since it is customary for corporations to take advantage of any


80. Model Act § 5, insolvency defined § 2(a) (see also comment); Alaska Comp. Laws Ann. § 36-2A-13, insolvency defined § 36-2A-2(n) (Supp. 1958); N.D. Rev. Code § 10-1905 (Supp. 1957), insolvency defined § 10-1902(14); Va. Code Ann. § 13.1-4 (1950), insolvency defined § 13.1-2(c). Three of the modern corporation states impose both equity and bankruptcy insolvency limitations on such repurchases. Md. Ann. Code art. 23, § 32(c) (1957); N.C. Gen. Stat. § 55-52(e) (Supp. 1959); Tex. Bus. Corp. Act art. 2.03(F) (1953). The remaining modern states, although some only impose the equity insolvency test, add additional limitations designed to protect prior or equal ranking shareholders from asset dilution. See N.C. Gen. Stat. § 55-52(e)(3)-(4), (f) (Supp. 1959); Ore. Rev. Stat. § 57.390 (Supp. 1959); Wis. Stat. Ann. § 180.385(1)(b) (1957). The District of Columbia Act, D.C. Stat. Ann. § 29-904a(d) (Supp. 1959), only expressly makes the insolvency test applicable to purchases of redeemable shares, and imposes the additional restriction (but only on reacquisitions of such shares) that the net assets will not be reduced below the aggregate amount payable to holders of shares having prior or equal rights upon dissolution. The failure to impose any insolvency limitation, except on reacquisition of redeemable shares, is not as dangerous as it first appears since general share repurchases may only be made from earned surplus. However, the three other Model Act capital reacquisitions are unrestricted by any insolvency limitation.

81. I.e., also "capital surplus," which includes all surplus which is not earned surplus. See Model Act § 2(m), and note 40 supra.


Thus, with but one exception, modern corporation statutes permit utilization of any surplus for share repurchases, provided formalities are complied with. See also Ohio Rev. Code Ann. § 1701.35(B) (Page Supp. 1959), which forbids purchases resulting in a diminution of assets below stated capital plus liabilities (= surplus).
permissive feature of the corporation statutes, it is to be anticipated that all corporations incorporated under these modern statutes will allow such purchases.

It may thus be fairly stated that under the Model Act, and its progeny, almost any corporation may repurchase any of its shares out of any type of surplus, no matter how created. Creditors can certainly have no legitimate objection to share repurchases from earned surplus, since their extension of credit is not justifiably made in reliance upon this fund as a security for payment. Purchases (such as those of redeemable and fractional shares) which might be undesirable if made from capital cannot be viewed as objectionable from the point of view of creditors where made from earned surplus, the corporation's profit, even though their position would of course be better still with the surplus unexpended.

83. Since earned surplus is universally utilizable, and if formalities are observed (i.e., charter provision or shareholder approval, where necessary), capital surplus (the rest of surplus) likewise becomes available, all surplus is therefore utilizable. The sole exception among modern corporation statutes, as the term is herein used, is the District of Columbia, which restricts general share repurchases to "actually" earned surplus.

84. Whether creditors actually do rely on capital or not is a mooted point. Certainly enlightened and large creditors do, if their requirement for personal guaranties of significant obligations in corporations which they suspect are undercapitalized is any indication (as has been the author's experience in the case of newly organized small corporations making large loans from banks). Whether they actually do rely, however, seems less significant than whether they have the "right" to so rely, a right which is not too high a price for businessmen to pay for the privilege of limited liability. On the other hand, while they might also prefer to have earned surplus at their beck and call, under traditional legal theory they have no such right to rely on this profit item as a guarantee for their payment. The proprietor of the corner stationery store who sells the corporation one box of pencils may not know or care about the difference between corporate capital and surplus. Since the legal distinctions have been in force for so long, however, it is not unreasonable to assume that larger creditors will apprise themselves of the capital-surplus situation of a corporation and guide themselves accordingly. See, as to the function of capital, Ballantine, op. cit. supra note 43, at 570-72. See the famous statement of Mitchell, J., in Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 198, 50 N.W. 1117, 1121 (1892):

Inasmuch as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon, the amount of its professed and supposed capital, and every one who deals with it does so upon the faith of that standing and reputation, although, as a matter of fact, he may have no personal knowledge of the amount of its professed capital, and in a majority of cases knows nothing about the shares of stock held by any particular stockholder, or, if so, what was paid for them. . . . The misrepresentation as to the amount of capital would operate as a fraud on such a creditor as fully and effectually as if he had personal knowledge of the existence of the defendants' stock, and believed it to have been paid for when he gave the credit.

As to creditor non-reliance on capital, see Guthmann & Dougall, Corporate Financial Policy 437 (3d ed. 1955), and some proof of the theory in Bing Crosby Minute Maid Corp. v. Eaton, 46 Cal. 2d 484, 297 P.2d 5 (1956).

85. If the latter are permitted. See note 76 supra where the necessity for such fractional shares is questioned.
Though creditors' preferences may be disregarded under the circumstances, there would seem to be no reason for allowing a corporation to purchase redeemable shares (even if only out of surplus) for more than the redemption price, since they might always be called at the latter price.\footnote{66}

While fractional shares may only be justifiably issued as part of a stock dividend, there would seem to be no reason why the issuing corporation should want to repurchase such shares at more than the amount allocated to capital on their issuance.\footnote{67} Otherwise, shareholders whose shares were repurchased would receive a dividend greater than that received by other shareholders, and would thus give the unfavored shareholders reasonable ground for complaint.

It is interesting to note that these restrictions, desirable even when the shares are being purchased out of surplus, are completely omitted by the Model Act even though it permits purchases for these very purposes to be made from the more sacrosanct capital.

Reasonable objections from the unfavored shareholders may perhaps be sufficiently satisfied by recommendations to be made later. Before dealing generally with shareholder rights in stock repurchases, however, certain creditor objections to such repurchases even out of surplus (as defined in the Model Act) should first be considered.

As indicated above, the Model Act permits share repurchases not only from "earned surplus" but also from "capital surplus," which includes every other type of surplus, since under the Model Act definitions capital surplus is that excess of net assets over stated capital which is not earned surplus.

The Act is, therefore, silent as to the problem raised by such cases as \textit{Randall v. Bailey},\footnote{88} a New York decision which held that an unrealized appreciation, due solely to the economic inflation, in the value of realty owned by a corporation would constitute surplus. Under the

\begin{footnotes}
\footnote{66}{Although the Model Act forbids such repurchases at more than the redemption price from capital, it does not make clear a similar limitation on the price to be paid where only surplus is used. It is followed in this ambiguity by all of the modern corporation laws, except Maryland (\textit{Md. Ann. Code art. 23, § 32(b)(1) (1957)}) and Texas (\textit{Tex. Bus. Corp. Act art. 4.09(A)(1) (1953)})}.

\footnote{67}{Neither the Model Act, nor any of the modern corporation statutes contain such a restriction. While purchases above par (or consideration allocated to stated capital from no-par shares) may be justifiable in the case of securities outstanding for some time, no such justification appears in the case of fractional shares which, as a corporate freak, will presumably be retired almost immediately after issuance.}

\footnote{88}{288 N.Y. 280, 43 N.E.2d 43 (1942). Fortunately, such "dubious" accounting policy is not widely followed. Ballantine, Corporations 541, 574 (rev. ed. 1946). See also Lattin, op. cit. supra note 71, at 477-79; Stevens, Corporations 451 (1949).}\end{footnotes}
Act, such surplus would be available for share repurchases and might effectively permit a "bail-out" of the shareholders of a faltering corporation at the expense of creditors (who would receive only small protection from the insolvency limitation) in any jurisdiction which chose to follow the *Randall* decision.

The obverse of the asset write-up coin is capital write-down, or a shrinking of assets on which creditors may depend to pay what is owing to them. The situation is especially dangerous for creditors since corporations in good financial circumstances (i.e., which have an unimpaired capital and a substantial *earned* surplus) will not resort to such techniques.

Under the Model Act, "reduction surplus," the result of a write-down of stated capital, would also be available for share repurchases. The Model Act, and the modern statutes influenced by it, are generous in allowing a reduction of "stated capital" in any case by two-thirds vote of the affected shareholders (sections 53 and 55), or even (under section 63) by mere majority shareholder vote, where the new stated capital is not below the sum of the aggregate par value of all shares plus the combined liquidation preferences of all shares having such rights.80

89. Such reduction of "stated capital" produces what modern statutes and writers refer to as "reduction surplus," a form of capital surplus, and thus available under most modern statutes for share repurchases. It is relatively easy for a modern corporation to reduce its stated capital, with the consequent diminution in the asset fund reserved for the creditors. In addition to automatic reduction through purchase or redemption of redeemable shares (Model Act § 61), voluntary reduction by retirement of other shares (Model Act § 62), and distributions in partial liquidation (Model Act § 41), a corporation may reduce the stated capital of no-par shares by majority vote of the voting shareholders (Model Act § 63) or, even if par shares are involved, by two-thirds vote of the voting shareholders of the corporation, plus two-thirds of the class affected (Model Act §§ 53(c), 54(c), 55(b)). Similar provisions for easy reduction of stated capital are found in the statutes of all of the modern corporation states.

<table>
<thead>
<tr>
<th>State</th>
<th>No-Par Capital</th>
<th>Other Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska Comp. Laws Ann.</td>
<td>§ 36-2A-81</td>
<td>§§ 36-2A-71, 72, 73</td>
</tr>
<tr>
<td>Colo. Sess. Laws 1958, ch. 32</td>
<td>§ 65</td>
<td>§§ 54, 55, 56</td>
</tr>
<tr>
<td>D.C. Code Ann. tit. 29</td>
<td>§ 61</td>
<td>§§ 52(e), 54(c), 55(b)</td>
</tr>
<tr>
<td>N.C. Gen. Stat.</td>
<td>§ 55-48</td>
<td>§§ 55-99(b)(5), 55-100(b)</td>
</tr>
<tr>
<td>Ore. Rev. Stat.</td>
<td>§ 57.406</td>
<td>§§ 57.355(2)(e), 57.360(2), 57.365(2)(b)</td>
</tr>
<tr>
<td>Tex. Bus. Corp Act</td>
<td>art. 4.12</td>
<td>arts. 4.01B(5), 4.02A(3), 4.03 B(2)</td>
</tr>
<tr>
<td>Wis. Stat. Ann.</td>
<td>§ 180.60</td>
<td>§§ 180.50(2)(e), 180.51, 180.52(1)(b)</td>
</tr>
</tbody>
</table>

* Only majority, rather than 2/3, vote required.
Surplus thus created is expressly made "capital surplus" (under section 64), and is hence available for share repurchase.

Through use by a corporation of either of these techniques, creditors may discover that what they justifiably considered to be capital has been legally filtered off to their detriment for the benefit of shareholders.

While not sufficient to obviate these problems, at the very least creditors should have the protection that no share purchases will be made if the corporation is insolvent, or would be rendered so by the purchases, in either the equity sense (as is required under the Model Act) or in the bankruptcy sense. This minimal requirement would seem essential to creditors since a dying corporation may still be able to meet its obligations as they fall due (i.e., be technically solvent in the equity sense), although its assets are less than its total debts (insolvency in the bankruptcy sense). Such a requirement is "built-into" the Model Act, but only in those cases where purchases are permitted solely from surplus.

Such ease of capital reduction is hardly unexpected in the face of the much more radical provisions of the Model Act (§ 53) and the modern corporation statutes which even allow the destruction of what lawyers used to call "vested rights" (a meaningless term, at least in today's corporation law): the right of preferred shareholders to cumulative dividends already due. See Gibson, How Fixed Are Class Shareholder Rights?, 23 Law & Contemp. Prob. 283 (1958) (especially table of statutes at 293).

90. See notes 58 and 80 supra.

91. See note 19 supra.

92. 1 Collier, Bankruptcy ¶ 1.19, at 93 (14th ed. 1956), suggests that the bankruptcy insolvency test may postpone the day when a corporation must suspend its business to a later date than does the equity insolvency test. It is submitted that this is often not the case. A corporation may often be insolvent in the bankruptcy sense, and still able to meet its debts as they mature, i.e., still solvent in the equity sense. See Note, 15 N.C.L. Rev. 199, 200-01 (1937). In Corey v. Wardsworth, 99 Ala. 68, 78, 11 So. 350, 353 (1892), the court declared: "At what stage of a corporation's affairs must it be pronounced insolvent, so as to bring it within the principle we have declared? It is not enough that its assets are insufficient to meet all its liabilities if it be still prosecuting its line of business, with the prospect and expectation of continuing to do so; in other words, if it be, in good faith, what is sometimes called a 'going' business or establishment. Many successful corporate enterprises, it is believed, have passed through crises, when their property and effects, if brought to present sale, would not have discharged all their liabilities in full."

Thus it would seem clear that a corporation may be a "going concern" even though bankruptcy insolvency is present. And it is precisely at this stage, just before inability to pay its bills finally forces the house of cards to collapse, that the temptation to bail out favored shareholders will be greatest. It is precisely at this juncture, therefore, that creditors deserve the assurance that the assets to be ultimately split by them will not be diluted by share repurchases.

See Barrett v. W. A. Webster Lumber Co., 275 Mass. 302, 175 N.E. 765 (1931); Nemmers, The Power of a Corporation to Purchase Its Own Stock, 17 Wis. L. Rev. 161, 170 (1942), demonstrating both that a corporation may be a going concern under the equity insolvency test and still bankrupt, and also the judicially approved use of its waning assets at this critical time to bail out shareholders by stock repurchases. Creditors deserve better protection than this.
and not in the extraordinary situations where purchases may be from either surplus or capital. Creditors will indeed suffer if a corporation can fritter away its liquid assets through legal share repurchases until the "house of cards" finally collapses in bankruptcy. Fortunately, some states have been foresighted enough to correct this Model Act deficiency.93

For truly adequate protection, a restriction on share repurchases which retains the asset fund at a level higher than that barely necessary to prevent bankruptcy is requisite. To forestall reduction of the assets to this dangerous level, it is important to restrict such purchases to surplus which has actually been earned, as opposed to allowing such repurchases to be made from a "surplus" which is, in reality, partly (or completely), diverted capital.

Authors usually speak of stated capital requirements as a protection for creditors.94 They are also a protection for the shareholders. Their effect is obviously to keep the asset fund at a level higher than that which would otherwise be the case. As such, they prevent the dilution of the real value95 of all shares. Asset disintegration through the

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93. See note 80 supra, listing states imposing both insolvency restrictions. It should be observed that an express addition of the bankruptcy insolvency test is not necessary where purchases are to be made only from "surplus," as defined in § 2(k) of the Model Act, since this test is already "built-in": surplus is the excess of net assets over stated capital, while net assets are the assets (excluding treasury shares) less the debts of the corporation. Therefore, even if stated capital be only nominal, there can be no surplus unless the assets are sufficient to cover all corporate liabilities. See Baker & Cary, Cases on Corporations 1025 (3d ed. abr. 1959). This is not true, however, for purchases permitted from stated capital, since they are not expressly restricted to net assets. Unless so restricted, a bankruptcy insolvency test is necessary to prevent dissipation of the asset fund through such capital purchases. For simplicity of statutory expression, however, a blanket prohibition of purchases resulting in bankruptcy insolvency seems sensible.

It should also be observed that the bankruptcy insolvency test may not be a mere redundancy even in the case of surplus purchases, since it requires a valuation of the assets at current market value. This figure may be less than the figure at which these assets are carried on the books. The "watered stock" case is a typical older example of such overvaluation, (see, e.g., Goodnow v. American Writing Paper Co., 73 N.J. Eq. 692, 69 Atl. 1014 (Err. & App. 1908)), which resulted in the existence of an artificial surplus utilizable for dividends and share repurchases to an extent which would not have been permitted under a bankruptcy insolvency test. An asset writeup, as employed in Randall v. Bailey, supra note 88, graphically illustrates the possibility of danger where only a surplus test is used.

Although imposition of the bankruptcy insolvency test might not have prevented the Randall fiasco because of the imprecision inherent in estimating market value, the requirement has the effect of increasing directorial caution by alerting them to the existence of another ground of potential liability for share repurchases in cases of borderline propriety.

94. Ballantine, op. cit. supra note 88, at 605; Stevens, op. cit. supra note 88, at 276. See, however, Ballantine, supra at 570, 572.

95. The "book value," Ballantine, supra note 88, at 531, or the amount which would be received on liquidation of the enterprise.
SHARE REPURCHASES

1959-60

Subterfuge of artificial creation and distribution of capital surplus is as detrimental to shareholders as it is to creditors, at least to those who are not bought out. Hence, for the protection of both creditors and shareholders, by and large, share repurchases should be limited to actually earned surplus, and not surplus in general, as the Model Act in effect allows.95

Shareholders also have grounds for disapproving unlimited purchases even out of earned surplus. As Stevens points out, one objection is:

Modern accountants may take exception to this equation of book value with the real value of stock. They may properly argue that no value based on a hypothetical liquidation return is realistic; since if actual bankruptcy liquidation did occur the assets would probably only bring a fraction (perhaps no more than a tenth) of the figure assigned to them as such liquidation value, and more important, that the real value of stock consists in its earning power, rather than in any proportionate share of such possibly unliquidable corporate assets. This, of course, is merely saying that there are defects in any estimate of value based on a balance sheet, which is really largely only a record of past expenditures. Unfortunately, however, creditors and stockholders alike have as their only security the retained assets of the corporation. The balance sheet may not reveal the exact value of these assets, but it does at least ordinarily reflect their cost, and, especially in the case of cash and receivables less debts, gives the most reliable indication of net worth which accounting has yet provided.

While it may not always be true, (e.g., a corporation may have a high total asset figure, but too many unproductive assets carried at an inflated cost, and too few liquid assets) a corporation with a high asset total is ordinarily better off than one with a lower level. Certainly, even in a very profitable corporation, creditors and shareholders have more of a prospective stake where the corporation has retained earnings, as revealed by a higher asset level on the balance sheet. Generally, whatever keeps the corporate asset level high is desirable from the point of view of creditors and shareholders.

96. A corporation’s assets are like a housewife’s measuring cup filled with flour. One calibration on the cup is bankruptcy insolvency (an amount equal to the debts), (ideally) a higher calibration is for stated capital, while (ideally) a still higher line marks the level of assets necessary for these plus capital surplus. Only a foolish housewife would throw away a part of her flour. Only a foolish shareholder would willingly deplete the asset level of the corporation by gifts to others. Money once spent to repurchase shares is “gone, and never must return,” hence both senior and junior shareholders (always excepting recipients of the money legally stolen from the remaining stockholders) have as much of an objection as creditors not only to purchases from capital but also to purchases from a fictitious surplus created out of capital. The sum total of the original money investment of all of the shareholders is equal not to the total stated capital, but really to that sum plus the total of capital surplus. Therefore, if original shareholders A and B each invest $100 for a share in a newly formed corporation, the effect of allowing purchases from other than actually earned surplus is to allow the corporation not only to fully repay B his original investment for exercising his privilege of withdrawing from membership (often more desirable to him than remaining in the corporation), but also to give him an additional bonus taken from the remaining shareholder’s (A’s) investment. In short, part of A’s $100 is taken to make a gift to B. This “robbing Peter to pay Paul” is the ultimate result of allowing share repurchases from other than surplus actually earned. Consequently, not only creditors but all shareholders, senior and junior, have a clear interest in having all share repurchases only made from earned surplus.
The agreement between them contemplates equal distribution of corporate losses and equal distribution of corporate assets, after the satisfaction of creditors. A shareholder may protest if the corporate purchase of the shares of another member will have the effect of increasing the burden of corporate liability of those who remain shareholders, for the fund applicable to corporate debts has been reduced by the amount of the purchase price. The corollary of this is that the pro rata share which each member will receive upon dissolution will be less than the amount which has been paid to the member whose shares have been purchased. This objection would be valid whether the purchase were made out of capital or out of surplus. In other words, each shareholder has a right to insist that, if the shares of any other member are purchased by the corporation, there will be a breach of the contract between the members, unless the price paid does not exceed that amount which the others would receive if the corporation were dissolved.

Partial protection to overcome this objection could be had by requiring the corporation to make a pro rata offer to purchase to all shareholders of the class at the same price. Any “bonus” on the purchase price.

97. Stevens, op. cit. supra note 88, at 278. Also see Ballantine, op. cit. supra note 88, at 609.

98. Such a formula as Stevens suggests, payment of no more than liquidation value, might be possible in the case of preferred shares, because the amount which they are to receive on liquidation is often fixed by their shareholder contract (often at par). See, however, Ballantine, op. cit. supra note 88, at 507-69, indicating that the liquidation value of even such shares may be different from their call value. The Model Act, of course, does attempt to do this in the case of redeemable shares (a term usually synonymous with preferred) by fixing the call price as the maximum amount payable on repurchase. However, as to common shares, this is either unworkable (e.g., at each purchase, good will would have to be evaluated and going concern and asset value recomputed), or so onerous (if interpreted to mean involuntary liquidation value, it would probably be so low as to effectively discourage any shareholder from selling, except in an artificially deflated market) as to effectively prevent all such repurchases. While Stevens’ proposal would offer more complete protection, it could not be considered as a feasible answer to the problem.

99. “Pro rata offer” here means “tender offer,” whereby a corporation would offer to repurchase, at a given price, a fixed proportion of each shareholder’s shares in a company. E.g., if there are 3000 outstanding shares in a corporation held by three shareholders, each holding the shares indicated in the following table, and each share having a market price of $10, the corporation might offer to repurchase as follows:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shares Held</th>
<th>Price Offered by Corp. Per Share</th>
<th>Shares Which Will Be Accepted by the Corp. Under the Offer</th>
<th>Voting Control Held Prior to Repurchase</th>
<th>Voting Control Held Subsequent to Repurchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1000</td>
<td>$11</td>
<td>25% = 250</td>
<td>1000 = 33 1/3%</td>
<td>750 = 33 1/3%</td>
</tr>
<tr>
<td>B</td>
<td>1500</td>
<td>$11</td>
<td>25% = 250</td>
<td>1500 = 50%</td>
<td>1125 = 50%</td>
</tr>
<tr>
<td>C</td>
<td>500</td>
<td>$11</td>
<td>25% = 250</td>
<td>500 = 16 2/3%</td>
<td>375 = 16 2/3%</td>
</tr>
</tbody>
</table>
price would result in the same equitable distribution of surplus as would a dividend (at least to those electing to sell), even if the price paid is over the market value (so long as the same price offer is made to each member of the class to purchase his shares in the proportion held). As long as his pro rata share of corporate surplus is distributed to him in this way, no shareholder has grounds for complaint. An alternative, where there were so many shares outstanding that a corporation could not afford to take even a small percentage of each shareholder's stock, or many very small holdings exist, necessitating fractional purchases, might be the selection by lot of the shares to which repurchase offers would be made.\footnote{\textsuperscript{100}}

The Model Act, of course, contains neither requirement of pro rata offer nor selection by lot. Such provisions, however, while protecting a shareholder from abuses in purchases from his own class, would still allow a corporation to buy up its common stock, thus undermining the equity of the preferred to the detriment of these shareholders.\footnote{\textsuperscript{101}}

If each shareholder sells the entire number of shares the corporation offers to take from him, the effect is merely a partial liquidation, which will result in the same equitable distribution of the corporation's surplus as a dividend, and also preserve the relative voting position of each shareholder. Problems arise, however, if any of the shareholders holds only 1 share, since then the offer to purchase would only be for \(\frac{3}{4}\) of a share in the example given, and this would necessitate the undesirable issuance of fractional shares. Similarly, if the security were traded on a securities exchange, "odd-lot" problems might be created by ownership of small numbers of shares. (Shares on a stock exchange are normally traded in lots of 100, or in the case of certain highly priced securities in lots of 10. Other quantities are called "odd-lots" and create special trading problems.)

To obviate such difficulties, an alternative procedure, such as that permitted by the New York Stock Exchange in redemptions, might be allowed: selection by lot of the shareholders to whom repurchase offers would be made. The New York Stock Exchange does not specify the manner in which drawing by lot should be conducted. The fairest system (rather than one lot for each shareholder's name or each certificate number) would seem to be one lot for each share of stock, identified, of course, as to ownership.

It should be observed that under a pro rata offer only those shareholders who elect to sell to the corporation share in the "dividend." All unpurchased shareholders obviously not only fail to share but suffer diminution of the fund available for real dividends to them. Moreover, the voting control remains the same only if each shareholder elects to sell all of the shares the corporation offers to buy from him. Under lot selection both dividend distribution and voting control are left to chance. For these reasons, approval of the shareholders of the class to be repurchased seems an additional safeguard necessary to the preservation of their rights. It should be further observed that under either system all shareholders of whatever class, whose shares are not repurchased, suffer an obvious decrease in the fund available for payment to them of real dividends. Hence, the approval of all classes of shareholders should be required for purchases from any single group.

\footnote{\textsuperscript{100}} Offers to repurchase on a first-come-first-served basis are a third possible alternative. Yet, they are difficult to administer fairly where the shareholders are widely scattered throughout the country, and require, as a result, too great statutory detail. They are therefore an undesirable method for solving the problem. See New York Stock Exchange Manual, note S8 supra, at A179-80.

\footnote{\textsuperscript{101}} Ballantine, op. cit. supra note 88, at 609, discussing the perils of share repurchases,
Some protection here, at least to those who choose to read the articles and not purchase preferred shares from corporations lacking such a qualification, could be had by expressly allowing a corporation to place any further restrictions (in addition to those contained in the corporation statute) on the exercise of the power to repurchase in its articles of incorporation, or even deny it altogether should it so choose. Such a provision might, e.g., forbid purchases of common stock over the objection of any, or a specified percentage, of the preference shareholders.103

Additional protection to these shareholders from harm through purchases of junior shares would be given by adding the limitation found in the North Carolina statute which forbids purchases "if at the time of or as a result of such acquisitions:

"(3) The highest aggregate liquidation preference of the shares to remain outstanding having prior or equal claims to the assets of the corporation would exceed the net assets of the corporation, or

"(4) There exists any unpaid accrued dividends or dividend credits with respect to any shares entitled to preferential dividends ahead of the shares to be purchased ..."

A third method of protecting preferred shareholders would be to require their approval, e.g., by two-thirds vote, of any purchases of shares junior (or equal) to them in dividend or liquidation preference before such purchases could be undertaken.

It should be observed that neither the Model Act nor any of its most slavish followers extend any of these protections.104 While all would observe: "They may be so used as to undermine the equity or margin of safety back of preferred shares, decrease assets and surplus and so defeat the reasonable expectations of preferred shareholders as to future dividends and also those in arrears." See also Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1371 n.62 (1935).

102. It is not clear under Model Act § 48(f)(i) and the last sentence, whether such a limitation would be effective. Such a charter provision gives only illusory protection unless it is made clear that the vote of the affected shareholders will be required for any charter amendment. Section 55(e) of the Model Act would have to be amended to make it certain that such a charter amendment would be construed as constituting a change in the "designations, preferences, limitations or relative rights" of these shares.

103. N.C. Gen. Stat. §§ 55-52(e)(3)-(4) (Supp. 1959). Interestingly enough, the Model Act itself contains similar provisions (§ 41(c)-(d)) but restricts their ambit to distributions in partial liquidation of the corporation. It also forbids purchase of redeemable shares which would reduce the net assets below the aggregate preferential amount payable to the holders of shares having prior or equal rights on liquidation. Since most preferred shares are redeemable, Ballantine, op. cit. supra note 88, at 509, the section at most protects preferred shareholders from purchases of other preferred shares. No protection is afforded the preferred shareholders from purchases of "common" shares, certainly as great a danger to them.

104. See, however, Tex. Bus. Corp. Act art. 2.03A (1953), which makes all repurchases subject to charter prohibition, and Wis. Stat. Ann. § 180.385(c) (1957), making purchases from other than earned surplus subject to charter approval or vote of "at least two-thirds
be indicated to give complete safety to senior securities from discriminating repurchases of junior shares, no statute can be said to offer even minimal financial safeguards without at least one of the above protective provisos. Junior shareholders, of course, themselves require for their own protection the fair treatment guaranteed by pro rata offer.

One might add that to protect members of the class being repurchased in any case where neither pro rata offer nor lot selection is required, or if permission to use other than earned surplus is retained, the statute should also require shareholder approval not only by superior classes, but also by the class to be repurchased itself, whether that class be ordinarily entitled to vote or not (as is usually true with senior shares, barring dividend defaults).

Otherwise, holders of a controlling block of common could divert all the corporate surplus to their own shares, however few, of a non-voting preferred. Furthermore, purchase of shares senior to their own offers a possibility of damage to all shares junior to those purchased. Many people, judges included, apparently forget that “what's gone is gone.” Money spent for senior shares is that much less for junior shares in dividends or liquidation value, and this is true despite bookkeeping entries to the contrary. The protection of junior shareholders not only demands pro rata or by lot offers to buy where purchases are to be made from their own class, but also requires their approval of all purchases from classes senior to them, since whatever goes to these senior shareholders means correspondingly less will go to them.

In addition to these deficiencies in financial protection offered to all shareholders under the Model Act and its modern followers, there is a further objection to these statutes rendering them especially unsatisfactory to the junior (voting) shareholders whose shares are the subject of repurchase. Stevens, writing with prescience before the appearance of the Model Act and its modern counterparts, thus phrased the objection:

The purchase by a corporation of its own shares may have an effect upon the voting power of the remaining shareholders and be objectionable to them on that score. It has been decided that the corporation’s acquisition of its own shares does not automatically effect a merger or a cancellation of the shares. The shares may be canceled, but, unless intentionally canceled, they remain divisible share interests which may be resold. Nevertheless, while the corporation holds its own shares, they may not be voted, and, by thus reducing the total number of votes which may...

\textit{of the outstanding shares of the same class and of each class entitled to equal or prior rank in the distribution of assets in the event of voluntary liquidation.}^\text{105}

\textit{Treasury shares are mere pieces of paper, having no more value than authorized but unissued shares.} Ballantine, op. cit. supra note 88, at 614-18. Yet some accountants have treated them as corporate assets, and have even been upheld by some American courts in doing so. Id. at 616-18. See also Hills, Statement of Legal Concepts of Accounting, 36 Iowa L. Rev. 198, 214-19 (1951); Nemmers, The Power of a Corporation to Purchase Its Own Stock, 17 Wis. L. Rev. 161, 183-84 (1942).
be cast at a shareholders' meeting, the number of votes required to constitute a majority is less than before the purchase. Consequently, a group who held 49 per cent of an outstanding total of 100 shares will control 51 per cent of the voting power if the corporation purchases and holds 4 of the outstanding 100 shares. Again, from the standpoint of the shareholder objecting on this ground, it will make no difference whether the purchase be made out of capital or surplus. His objection in this instance is not the fundamental one that the corporation lacks authority to acquire its own shares, but rather that the directors or the majority shareholders are using their power to work a fraud upon him.106

The suggested requirement of pro rata offer insures that relative voting position will be maintained even when voting shares are being purchased, at least if all shareholders accept the offer.107 To overcome the necessity for pro rata offer (pro rata purchase such as is required by section 55-52(c)(1) of the North Carolina Business Corporation Act is impractical since refusal of any shareholder to sell would defeat the entire purchase plan), an alternative requirement of two-thirds shareholder approval by the class to be purchased is probably high enough to prevent imposition in most cases.108 However, this dispensation should be limited.

107. See note 99 supra. As to pro rata offer, see Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 Col. L. Rev. 971, 1003 (1935); Nemmers, op. cit. supra note 105, at 175.
108. Presumably shareholders will not vote to disenfranchise themselves by a transfer of voting control, except under the most compelling circumstances. Such a requirement of course only protects such voting shareholders from such practical disenfranchisement, and not from other abuses. It is even possible to derive a formula for taking over a corporation with its own money (i.e., the stockholders' money). The formula for shares required to be purchased by the corporation to secure control with any number of shares is:

$$z = \frac{px - M}{p},$$

where $x$ equals the total number of shares outstanding; $z$ equals the number to be bought by the corporation; $p$ equals percentage necessary for control, and $M$ equals shares already secured to management.

By contrast, if the individual directors sought to secure the same control through purchases of shares with their own money, the formula would be: $z' = px - M$. A share bought by the corporation with its money is therefore worth "$p" times as much as a share bought by the directors on their own account. Although more shares must therefore be bought in the corporation's name than would be required if the individuals bought for themselves, such control may be purchased for themselves without any expenditure of their own money. Wise purchases partly on their individual, and partly on the corporation's account, may be employed to secure control and also maximize their individual share participation as far as resources allow. The shares to be purchased by the corporation when the directors' individual resources are exhausted can be easily computed by taking the amount needed under formula 2, subtracting the number of shares the directors can afford for themselves, and dividing $z'$ by $p$. For example, if there are 100,000 ($x$) shares outstanding, and management, certain of 40,000 ($M$) of them, can afford to purchase 10,000 in its own right, and need 2/3 approval for liquidation, it may insure the acceptance of the plan by use of the corporation's surplus to purchase 25,000 shares of the remaining
SHARE REPURCHASES

The Model Act and most modern statutes, devoid of both safeguards, leave the danger unremedied.

Purchases of senior shares may be used to divert surplus otherwise available for dividends to junior shares to such preference issues. Purchases of junior stocks may dissipate surplus even below that necessary to assure payment of the fixed dividend preferences of senior issues. Consequently, the only safe provision is to require purchases of shares of any class to be approved by all classes whether normally voting or non-voting. ¹₀⁹

Under section 61 of the Model Act only redeemable shares are automatically cancelled by repurchase. Other shares¹¹⁰ may be resold by the corporation as it pleases.¹¹¹ Therefore, not only may management

50,000 shares. The advantage here is patent. If the corporation has an initial surplus of $1,000,000, and can acquire needed shares for $1 each, the directors will make an additional $30,000 on the 10,000 shares purchased for themselves over what they would have received on those same shares had the repurchase of the 25,000 shares not been made by the corporation ($130,000 as opposed to $100,000).

109. An alternative designed to achieve this protection is found in some modern statutes. E.g., Tex. Bus. Corp. Act art. 2.03(C) (1953) provides: "Upon resolution of its board of directors authorizing the purchase and upon compliance with any other requirements of its articles of incorporation, a corporation may purchase its own shares to the extent of unrestricted earned surplus available therefor if accrued cumulative preferential dividends and other current preferential dividends have been fully paid at the time of purchase." See also N.C. Gen. Stat. § 55-52 (Supp. 1959). Shareholder approval by all classes (as recommended) is also required, but only for repurchases out of capital surplus. Tex. Bus. Corp. Act art. 2.03(D) (1953); see also N.C. Gen. Stat. § 55-52(C) (Supp. 1959). Also note Wis. Stat. Ann. § 180.385 (1957), which provides for repurchases where: "(b) The net assets of the corporation remaining after such acquisition would be not less than the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of voluntary liquidation; and (c) Such acquisition is authorized by the articles of incorporation or by the affirmative vote or the written consent of the holders of at least two-thirds of the outstanding shares of the same class and of each class entitled to equal or prior rank in the distribution of assets in the event of voluntary liquidation." See Ohio Rev. Code Ann. § 1701.35(A)(9) (Page Supp. 1959).

110. According to Ballantine, op. cit. supra note 88, at 450-91, there are no preemptive rights in treasury shares. See Stevens, op. cit. supra note 88, at 500, 511. N.Y. Stock Corp. Law § 39(4)(c) expressly denies such preemptive rights unless the certificate provides otherwise. In Hammer v. Werner, 239 App. Div. 38, 265, N.Y.S. 172 (2d Dep't 1933), which antedated the statute, the court held that preemptive rights may exist in treasury shares under some circumstances. See Lattin, op. cit. supra note 71, at 426; Note, The Preemptive Right of Shareholders to Subscribe to New Stock, 11 N.Y.U.L. Rev. 78 (1933). N.C. Gen. Stat. § 55-56(b) (Supp. 1959) expressly grants such preemptive rights except where limited by the articles of incorporation (§ 55-7(4)(f)).

111. Ballantine, op. cit. supra note 88, at 614; Baker & Cary, op. cit. supra note 93, at 849. Under the Model Act, besides the dangers here outlined, the possibilities for "stock watering," as a result of the corporation's right to sell such shares at market, as opposed to par, are obvious. Donations or repurchases of shares issued in exchange for overvalued
manipulate control in the way Stevens suggests, but it can transfer that control to its own members, or their friends, as individuals, by carefully planned bargain sales. The effect not only perpetuates management in power, but gives its members equal dividend and liquidation participation at nominal cost with those shareholders who have paid full value for their shares. Under such statutes the normal rule that directors are uncompensated for their "services" to the corporation may well become a travesty.

Resale of treasury shares should therefore require the same shareholder approval as their repurchase, or, at least, the statute should grant preemptive rights in their resale. It is to be noted that neither method will be effective if the original purchases have caused the shift in the balance of corporate power against which Stevens cautioned, since they may do nothing to rectify that shift. This danger merely serves to emphasize the necessity for pro rata offer and shareholder approval on the original repurchase.

V. POSSIBLE EXCEPTIONS

From the foregoing discussion, one may conclude that a statute offering minimal protection to creditors and shareholders of a corporation would: (1) never permit share repurchases out of capital, except to pay the appraisal value of shares to stockholders entitled to receive such payment; and where the shares were reacquired in compromise of an indebtedness due to the corporation, with the further limitation that even such reacquisitions must be in good faith; (2) that, with such exceptions, only earned surplus be allowed for share reacquisitions, and

"property" sold to the corporation enable the corporation to resell these shares to "suckers" at a bargain price of less than par—but still over true value. See Ballantine, op. cit. supra at 617. Section 23 of the Model Act is so drawn as to afford little protection against issuance of such watered shares. In fact it seems to legislate the New York common law rule that holders of watered stock are under no liability to pay the par of their shares if their agreement with the corporation is otherwise. Christensen v. Eno, 106 N.Y. 97, 12 N.E. 648 (1887); Southworth v. Morgan, 205 N.Y. 293, 98 N.E. 490 (1912). Model Act § 24 allows a corporation to deny preemptive rights to purchase treasury shares. Ballantine, op. cit. supra, at 617, suggests that reacquired shares be restored to the status of authorized and unissued shares. This might well not give preemptive rights on their resale. Id. at 489. See also Lattin, op. cit. supra note 71, at 426.


113. The doctrine of preemptive right and pro rata offer are both facets of a similar policy of protecting shareholders from dilution of the asset and voting value of their shares, and are thus natural complements.

114. I.e., "actually" earned surplus, as defined note 58 supra. Restricting purchases to actually earned surplus has the advantage of lessening the utility of capital reduction, over-allocation of no-par consideration to surplus, and asset write-ups. For if the "surplus"
that even repurchases from this surplus be required to be by pro rata offer, or by lot, with any resales of uncancelled shares carrying preemptive rights; (3) that repurchase and resale require express shareholder approval, at the time of such repurchase,\textsuperscript{110} by two-thirds vote,\textsuperscript{110} not only of the class to be repurchased, but also of all classes senior and junior thereto, regardless of voting rights; (4) that no reacquisition be made when the corporation is, or would be rendered, insolvent in either the equity or bankruptcy sense.

The question naturally presents itself as to what exceptions, if any, are to be allowed from the strict limitations suggested.

As was indicated above, contracts requiring the corporation to repurchase shares are not uncommon in three different situations: (1) as part of an original share subscription contract, (2) where the shares are issued as part of an employee incentive plan, (3) in a "close" corporation to insure that on the retirement or death of one of the participants the corporation will remain "close," i.e., that the remaining "partners" may control entry of the replacement into the enterprise.

Ballantine is especially severe on the first type of contract, despite its general judicial acceptance:

There has been a good deal of recognition of the validity of agreements, made as part of a subscription to shares, to repurchase them on the demand of the subscriber if the subscriber becomes dissatisfied with his investment. Such repurchase agreements are generally part of some stock selling scheme by high pressure salesmen. Some courts have even made a judicial exception in favor of this practice under statutes restricting withdrawal of 'capital stock' or forbidding purchases except out of surplus. Specious reasons have been assigned to explain the upholding of such escape provisions, as that the transaction is only a conditional sale or a 'sale and return contract,' and that the corporation cannot retain the subscription price and at the same time repudiate the illegal agreement to repurchase. This is even carried so far as to validate an agreement to pay a premium on repurchase and to pay thus created cannot be used for share repurchases (and dividend payments), it becomes less desirable for the corporation to circumvent the stated capital limitation by such techniques. The effect is thus a protection of creditors, and the body of unrepurchased shareholders, from diminution of their asset fund.

\textsuperscript{115} To prevent imposition on subsequent innocent (i.e., unsophisticated) share purchasers who will not normally read the charter nor the by-laws or minutes passed by the incorporators.

\textsuperscript{116} Such a high requirement would not seem undemocratic. It is, after all, the percentage required for constitutional amendments and legislative overriding of presidential or gubernatorial vetoes. Furthermore, a corporation is really a plutocracy in which one individual may carry much greater voting power than he would in a political election. Hence he has a correspondingly greater power to inflict harm on minority shareholders. Despite the understandably greater voting power due to greater financial stake in the corporation, the proportionately greater danger of imposition seems to justify the high vote requirement utilized even in a political democracy.
interest as part of the purchase price, obviously illegal. *Such agreements, used to entice reluctant and inexperienced subscribers, should be condemned as dangerous to creditors and unfair and discriminatory as against other shareholders even if creditors are not immediately threatened.*

The pernicious nature of such agreements, often unknown to other unfavored shareholders, should be sufficiently obvious. They allow selected shareholders of a financially shaky corporation to escape with their entire investment intact at any time before insolvency. This is palpably unfair to the other shareholders, to say nothing of creditors. Even were repurchase to be at a price no higher than the shareholder’s liquidation proportion of the assets, and paid completely from surplus, the repurchase would be objectionable as a device for manipulating voting control.

When recourse to such agreements must be had, e.g., if no other means of raising money for the corporation is available, they should only be permitted with full knowledge and two-thirds approval of the shareholders. *No exception should be made for such purchases, except from the requirement of pro rata offer.*

117. Ballantine, op. cit. supra note 88, at 613-14. (Emphasis added.) Stevens, op. cit. supra note 88, at 283, states that such repurchase agreements are generally upheld when repayment can be made out of surplus.

118. This choice should be made by the actual investors in the corporation, not by dummy incorporators or subscribers, who have no financial interest in the corporation, and hence no qualms about committing it to a policy basically unfair to later shareholders. The approval of these repurchase agreements should be postponed until the corporation is really under way, i.e., in the control of the actual owners of the enterprise, who stand to be harmed by such agreements. On the other hand, the unavailability of such devices in the promotional stage of the corporation may well prevent successful exploitation of new, and socially desirable, inventions for want of the availability of more conservative financing. The value decision which must be made here is difficult, involving a weighing of the social interest against that of the individual shareholders and creditors of the enterprise. These interests conflict since if any shareholder is allowed to withdraw, the corresponding debt burden of the remaining shareholders is pro tanto increased and the total fund for creditors diminished. An appropriate adjustment would subject all shareholders to the same perils during the most crucial period of corporate life, its inception, but allow those whose initial contribution is so valuable to their fellow shareholders, as to justify special treatment, to stand in a position between that of shareholder and real creditor after this initial crisis has passed. This can be accomplished by allowing the shareholders (who by this time will be the actual investors in the corporation) to agree by suitable vote, e.g., two-thirds of all classes, to such a repurchase agreement after a sufficient period has elapsed since incorporation, say, one year, to insure that those with the real financial stake in the corporation will accept the consequences. Financiers will, of course, be forced during the formation period to choose between a genuine creditor status and the risk of gain or loss consequent upon genuine shareholder status. They may “hedge” (and if their participation is truly vital they will be given this additional advantage by the incorporators) by insisting upon options to purchase shares which might be made redeemable on the holder’s election if the shareholders gave the requisite approval at the later date suggested.
Moreover, case law in some states has created another strange and hidden danger to creditors and shareholders by allowing shareholders who have been given notes for their repurchased shares to come in as general creditors on an insolvency distribution.\textsuperscript{119} Even though shareholders who have been completely repurchased in a bona fide transaction may fairly be said to take priority over the corporate shareholders on such an insolvency distribution, the danger of abuses would seem to dictate that their claims be subordinated to those of general creditors.\textsuperscript{120}

Yet another defect of the Model Act is its silence regarding repurchase agreements, and its failure to fix clearly the time for application of the insolvency test. If the test is to be applied at the time of the contract, the corporation will usually be solvent, and the transaction, therefore, permissible. If applied when the shareholder elects to enforce his rights to sell, or be paid, the opposite may well be true. Clever shareholders may thus be able to secure for themselves all the benefits of shareholders if the business prospers, while at the same time possessing all the safeguards of creditors if the business fails.

The 1957 revision of the Model Act, apparently designed to correct this ambiguity, now forbids not only purchase of, but also payment for, its shares when the corporation is or would be rendered insolvent by such "repurchase or payment." Nonetheless, the ambiguity remains. How, for example, is an agreement to repurchase made while the corporation is solvent, but payable by notes some of which mature after insolvency has occurred, to be treated? Is the noteholder to be denied all participation even with that of shareholders? Must all earlier payments be refunded? The answer would be to subdivide these claims to those of general creditors, but allow them priority over unrepurchased shareholders. Such persons are centaurs: half creditor, half shareholder. It is only appropriate to treat them as such, unambiguously.

Agreements to repurchase shares, therefore, should be accorded special treatment. Yet, instead of special exceptions in their favor, such repurchases should be subjected to an additional limitation, namely, that for the insolvency test the time of enforcement of the contract will control, and that if the shares have already been surrendered and a corporate obligation given, the obligation will be subordinated to the rights of general creditors on such insolvency.\textsuperscript{121}

\textsuperscript{119} See, e.g., Wolff v. Heidritter Lumber Co., 112 N.J. Eq. 34, 163 Atl. 140 (Chan. 1932); Barrett v. W. A. Webster Lumber Co., 275 Mass. 302, 175 N.E. 765 (1931); see also Stevens, op. cit. supra note 88, at 284-86. The better rule is to subordinate such claims to those of general creditors. See Stevens, op. cit. supra note 88, at 286, and cases cited therein; Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 89 U. Pa. L. Rev. 697, 703-04 (1941).

\textsuperscript{120} Some cases have so held. See Stevens, op. cit. supra note 88, at 286 n.53.

\textsuperscript{121} The 1953 revision of the Model Act made no attempt whatsoever to deal with this
Furthermore, the requisite shareholder approval should be given a sufficient time after the corporation has actually commenced business to prevent "dummy" ratification by technical shareholders often used to effect incorporation for those really interested.\(^\text{122}\)

The second and third types of repurchase contracts seem, in general, more justifiable. Employee purchase of shares at a discount does stimulate better efforts in behalf of the corporation,\(^\text{123}\) but this advantage ceases when the employment terminates, and prudent management therefore requires the departing employee to surrender his shares and rights to purchase shares. A pro rata offer should not be required on such repurchases, and the original authorization for the employee's incentive plan\(^\text{124}\) should be sufficient if it contains the repurchase provision. The same dangers inhere in the incentive share plan as in any contract to repur-

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\(^{123}\) Preferred shares granting the holder the option to demand redemption are of the same genre and equally pernicious. See Dodd, supra note 119, at 730-34. Objectors to this stringent requirement may argue that money will thus become unavailable for worthwhile enterprises pioneered by the "idea" men who have little cash of their own. The difficulty can be solved. Lenders to the corporation have the rights of creditors. If the financier requires additional inducement, he may always extract from the individual shareholders initiating the enterprise an option allowing him to purchase a portion of their individual shares which is exercisable by him at a time sufficiently removed from inception so that the corporation will show either promise of becoming successful or the opposite. Such an arrangement may give rise to a (successful) objection on insolvency by creditors that the financier was a shareholder, and hence not entitled to equal treatment with them. But it would be no worse for the financier in this regard than an initial share repurchase agreement, and the arrangement would protect the shareholders of a solvent corporation from possible deviation of their surplus to one favored shareholder in a period of secular decline. See note 118 supra.

chase. Yet, where circumscribed by the same limits, i.e., two-thirds shareholder approval, the plan should be even less objectionable. If repurchase terms are initially authorized by the requisite shareholder approval, no express authorization should be required on actual repurchase at market value,\textsuperscript{125} provided that the corporation be solvent immediately after the authorization of the plan, and that, the actual reacquisitions are made when the corporation is solvent, or, at least, the employee should be subordinated in rights to other creditors, regardless of the form of the transaction.\textsuperscript{126}

Similar considerations would seem to justify agreements to repurchase by a close corporation from earned surplus. Shareholder agreements should be drawn here to give the corporation an option to repurchase.\textsuperscript{127} The corporation may assure itself of sufficient surplus to exercise this option on the death of a participant by appropriate insurance policies. In other situations, the corporation should be allowed to repurchase, but only with the requisite shareholder approval of the corporation's participation in such an initial shareholder agreement, and out of earned surplus.\textsuperscript{128} Stockholder agreements should provide for purchase by individual shareholders (pro rata) if the corporation is unable to exercise the option in such circumstances. Where all the shareholders are parties to a restrictive shareholder agreement, and the corporation assents, however, it would seem an unnecessary formality to require separate shareholder approval at the actual time of repurchase.

Thus, with the above qualifications indicated, no special exceptions need be granted for corporate contracts to repurchase shares.

Generally speaking, no special exception is needed to buy out recalcitrants. If they are merely obstructionists, it should be easy to secure the requisite two-thirds shareholder approval authorizing repurchase of their

\textsuperscript{125} Or, as every prudent corporation will require, at some amount below market. A pro rata offer should not be required for such repurchase.

\textsuperscript{126} I.e., even though the "repurchase" may have been made before technical insolvency, and notes given which are sought to be enforced after such insolvency has taken place. Such a plan prefers such employee shareholders over other shareholders of the corporation. Since "employees" may include officers, directors and large shareholders, Rogers v. Guaranty Trust Co., 288 U.S. 123 (1933), were such employees given parity with general creditors, a loophole for selective favoritism of certain shareholders over creditors, through equal participation with them, would be created similar to that possible with repurchase agreements as a part of share subscriptions. The possible benefit of such plans to the corporation (creditors and fellow shareholders) would seem, however, to justify at least a priority over remaining shareholders once the obligation to repurchase has matured.

\textsuperscript{127} See notes 33 and 34 supra.

\textsuperscript{128} Of course, if all shareholders and creditors approve any transaction, it should be allowed. Once shareholders and creditors consent, there can be no objection (provided future creditors and shareholders have notice) even to purchases from capital.
shares. Of course as with the previous “exceptions” considered, pro rata offer would here seem inappropriate.

Any over-all grant to repurchase shares of obstructionists would, naturally, be open to extensive abuses, as would an unqualified grant to purchase shares to prevent the takeover of a corporation by prospective looters:129 too many persons could fit themselves into the appropriate categories should the opportunity present itself.

With regard to purchases to “make a market” for new corporation issues, Stevens raises the following objection, which, incidentally, he does not regard as sufficiently dangerous in itself to justify an absolute prohibition:

129. As to repurchases for this purpose, see Baker & Cary, op. cit. supra note 93, at 597. Quere: if directors would not have a fiduciary duty to repurchase shares for the corporation to prevent takeover by prospective looters, if the repurchase could be made legally. See Ballantine, op. cit. supra note 88, at 609-10, 621-24.

130. Stevens, op. cit. supra note 88, at 280. Stevens terms such activity an ultra vires risk not contemplated in the articles of incorporation. Under modern corporation laws which expressly grant the power to repurchase shares, this objection seems no longer tenable.

131. See Nussbaum, supra note 107, at 986. As has been observed, see notes 37 and 38 supra, “stabilizing” purchases are not forbidden, however, and it is often difficult to draw the line. Nemmers, supra note 108, at 166, approves purchases to support the market.

 Trafficking in corporate shares has another aspect. It has been suggested that ‘dealings by a company in its own shares tend inevitably to breaches of duty on the part of the directors, and to fraud and rigging the market on the part both of the corporation itself and of its officials.’ The legal and ethical aspect of a director's conduct when, with inside information as to corporate plans and prospects, he purchases or sells shares in his own corporation, has been considered elsewhere. The situation is analogous when the purchase or sale is made by the corporation itself, for it is made at the instance of the directors or officers, who possess information not shared by other members, and whose motive in making the purchase or the sale is the profit or advantage which the corporation will gain, even at the expense of the individual from whom shares are bought or to whom shares are sold.130

“Market rigging”131 is already restricted by the rules of the SEC. Limited corporate purchases within federal and stock exchange regulations may be desirable. Still, a general exception for corporate speculation in its own shares is very dangerous. Management’s activities should be directed to the improvement of the corporation's legitimate business, and any general exception for such speculation would, if not inevitably result in a breach of director’s duties and market rigging, at least constitute an undesirable distraction from their obligation to further the corporation’s business. Should any further warning be necessary, though, one might recall the South Sea Company’s speculation in its own shares
which contributed that infamous chapter of corporation law known as the "South Sea Bubble." {132}

Even with the additional safeguard that insiders' short-swings profits on such speculations (if corporate purchases are used to elevate the market, shareholders controlling such purchases are able to profit by timely sales of their individual shares) are recoverable by the corporation under section 16(b) of the Securities Exchange Act of 1934, {133} such purchases would not seem worthy of encouragement by special favoritism because of their inherent dangers.

Nevertheless, a concession may be made to accommodate legitimate purchases, including all of the above, to an extent not overly dangerous. Limited purchases from earned surplus without pro rata offer and two-thirds shareholder approval for each transaction might be permitted by appropriate charter provision, or better by a blanket grant given a sufficient time after organization, to obviate mere "dummy" approval, by two-thirds of the shareholders. Since such purchases, albeit limited, always diminish the amount available for dividends to the remaining shareholders and may shift a closely divided voting control, they should never exceed a small percentage of the outstanding shares. Permitting a corporation to hold at no time more than five per cent {134} of its out-

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{132} Benjamin, The South Sea Bubble 114 (1921). As to the techniques used by the South Sea Company, see Lunt, History of England 509-10 (3d ed. 1946).


{134} This figure would certainly seem high enough for any legitimate purchases. E.g., Rule U-42(b)(3), (6), promulgated under the Public Utility Holding Company Act of 1935, 49 Stat. 838 (1935), 15 U.S.C. §§ 79-79z-6 (1958), allows share acquisitions by holding companies regulated thereunder up to 2% of their stock or $50,000 in value. This percentage is likewise much higher than is needed for legitimate stabilizing activities. The underwriters in the Fedders-Quiggan Corporation (now Fedders Corp.) 1951 rights offering, one of the most unsuccessful of such attempts to market new securities in recent New York Stock Exchange history, were only forced to buy 2200 shares of the common stock out of 1,240,820 in their attempt to make a market for the new offering. See Supp., Nov. 26, 1951, to Prospectus, Nov. 9, 1951.

Corporations listed on the New York Stock Exchange are required under the current listing agreement to report all acquisitions and disposions of their own shares to the Exchange. New York Stock Exchange Company Manual § 1(7), at A-24. Out of about 1100 different businesses listed on the Exchange, comparatively few do any dealing in their own shares. In the February 18, 1959, published report of changes in the number of reacquired shares held by listed companies as treasury stock, only 30 companies reported a net increase in the number of their own shares held, and only 45 reported any transactions in their shares, even though for 20 of the corporations reporting the period covered was three months (for the remaining 25 the report was of charges during the preceding month). Of these, 19 reported a balance of treasury shares on hand of over 5%. However,
standing shares would seem a maximum generosity to possibly legitimate repurchases, considering the dangers which all repurchases, even out of earned surplus, produce to shareholders. Despite the uncertainty of such a criterion, 135 such purchases should probably be made subject to a requirement of good faith. Such a proviso will give courts the additional leeway necessary to set aside or enjoin purchases envisaged by management for any improper purpose which render the general restrictions advisable.

only 10 companies reporting changes in their holdings of treasury stock ended up with more than 5% of their common at the end of this period. Ten companies reporting held more than 5% of both their preferred and common. Such reports are not cumulative as to holdings of treasury stock, i.e., they only reflect changes in the number of shares held and balance during the reporting period, and, therefore, do not include such astounding share repurchases as those of American-Hawaiian Steamship Company which, by reacquisition of its common stock, reduced its number of shareholders to (it was believed by the Exchange) only 125 (discounting odd lots), despite an outstanding common as of April 2, 1959, of 500,000 shares (Fitch's Stock Quotations on the N.Y. Stock Exchange, April 2, 1959, p. 2). N.Y. Stock Exch. News Release, March 26, 1959. Nor do the figures include shareholdings of such companies as Crescent Petroleum Corporation, which reported no change in its holdings of treasury stock, but as of January 13, 1959, held 1,123,864 out of 2,733,800 of its common shares in treasury. Report to N.Y. Stock Exch., Jan. 5, 1959, of no. of shares in treasury on Dec. 31, 1958. Probably corporations engaging in such extensive share repurchases are in the minority. The report would indicate that, although those which do deal actively in their own securities may do so with a vengeance, there are very few corporations which attempt such trafficking in their own shares.

Yet, the statistics do indicate that perhaps too much faith has been placed in the SEC and the New York Stock Exchange rules as foreclosing the possibility of a corporation's trading in its own shares, and that greater regulation by state incorporation laws is advisable. There would appear to be no valid reason for corporations to hold as many shares in their treasuries as this minority of corporations does. There is, of course, good reason for reacquisition of preferred stock, to free common stock from the dividend burden such stock entails. However, if such shares are reacquired for this legitimate purpose, they should be retired, rather than carried in the treasury. There would seem to be even less reason (unless to perpetrate one of the abuses cautioned against) for large treasury holdings of common stock.

In any event, if large numbers of shares are to be reacquired for some worthwhile purpose, such as to be available for an employee stock option plan, or acquisition of another corporation, this may be done under express authorization suggested elsewhere, and an unlimited right to reacquire and hold 5% of its shares of each class should certainly be ample for every other worthwhile purpose.

135. Nussbaum, supra note 107, at 982-83, argues that the "good faith" test has been ineffective to prevent abuses. The test at least supplies judges desirous of engrafting traditional fiduciary limitations onto the power of share reacquisition with a statutory justification for doing so. For a similar technique to prevent abuses which no statute can ever completely foresee and restrict, see the Uniform Commercial Code 1-203: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." See note 64 supra.
Most legal writers who have examined the problem of a corporation's repurchase of its own shares have condemned the generally permissive American rule. Perhaps they still hope, with Milton, that "time will run back and fetch the age of gold": the strict rule prevailing in England and other countries. In the face of the almost universal permission accorded by American law to some form of corporate share repurchases, and the ever more sweeping grant given by modern corporation statutes, led by the Model Act, such expectation is too sanguine, at least until America suffers a South Sea Bubble, or an economic crisis like that experienced by Germany after World War I. Until such unwelcome disasters, critics of unrestricted corporate share purchases will remain unheeded voices crying in the wilderness.

As was suggested at the outset of this article, perhaps things are as they should be. Certainly, the two principles originally presupposed are valid—democratic government is based on them—adequately established popular approval should be binding on the entire group, including dissenters, and an individual should be bound by a choice rationally made (i.e., with awareness of the possible consequences, or, what is the same thing, the reasonable possibility of such awareness).

It was submitted, as a conclusion from these premises, that shareholders and corporate creditors could legitimately be held to those risks involved in purchasing shares from, or extending credit to, a corporation, where fair notice was had of the dangers involved. Unfortunately, under the Model Act and the statutes which follow it, the only choice given to the individual investor or creditor consists of taking an almost complete risk—casting caution to the winds—or of not dealing with a corporation at all.

It is, however, also submitted that no legislature in the country intends to allow share repurchases by a corporation which would be unjust to creditors and fellow shareholders. Whether or not creditors do in fact rely on the "capital" of a corporation, they should have the right to rely on a certain minimal asset fund available for the satisfaction of their debts: a legal limit below which they are sure a corporation shall not go.

A general requirement, with as few exceptions as possible, that capital remain unimpaired lends some protection in insuring the existence of such a minimal asset fund. Nevertheless, unless modern corporation statutes are revised to make this stated capital more inviolable, or the

136. Nussbaum, supra note 107, at 978.
137. Id. at 976-77.
138. Id. at 972-75.
"surplus" created therefrom less available for indiscriminate corporate use, it is alone insufficient protection for these creditors. The capital may be diminished below a level equal to outstanding debts, since it bears no necessary relation to them.  

Imposition of the bankruptcy test for insolvency, apart from other restrictions, might give a minimal asset protection to creditors, for capital would not be dissipated through share repurchases below a level equal to what is owed them. It should be remembered, however, that neither the Model Act nor most of its modern counterparts accord them even this minimal protection. At most, though, this affords the barest protection to creditors, and none at all to shareholders.  

The equity insolvency test, standing alone, is even less adequate. Being less objective, it allows greater latitude for dubious director action.  

Although stated capital need not necessarily be so pegged, it often fixes a higher asset level than the mark set by the bankruptcy insolvency test, and thus often provides an additional protection over the bare minimum. Therefore, as creditors deserve, and probably all legislatures really intend to provide, adequate creditor protection requires the imposition of all three limitations: no share repurchases should be made when insolvency in either the bankruptcy or equity sense is present or threatened, nor, except in the extraordinary circumstances outlined above, from stated capital.  

A restriction against purchases from capital, in addition to both insolvency restrictions, is also a sine qua non of adequate senior shareholder protection for basically the same reasons. Senior shareholders usually have liquidation preferences. Hence they are just as legitimately interested as creditors in having the fund on which they may draw for satisfaction of their claims as large as possible. Unlike creditors, however, a bankruptcy insolvency test does not supply them with any real protection. Since they are not debtors of the corporation, this test only forbids purchases taking assets below the amount of outstanding debts, 

139. An obvious example would be a corporation with a very large bond indebtedness and no-par common stock from the consideration received for which only a nominal amount had been allocated to stated capital, the "ideal" undercapitalized corporation.  

140. See note 80 supra.  

141. A corporation may, by judicious borrowing or securities flotations, postpone the day of creditor reckoning, although it may be insolvent in the bankruptcy sense. See note 92 supra. An honest balance sheet is less easily deceived.  

142. This should be true in the case of all corporations with a sound leverage ratio. As to leverage ratio, see Guthmann & Dougall, Corporate Financial Policy 102-03 (3d ed. 1955).
i.e., it does not guarantee that anything will remain for them after the creditors have been paid. Only stated capital, protected against impairment, will provide any safeguard. Further, as investors in the corporation with the greater risks consequent upon that status, they have a justifiable claim not only to the protection afforded creditors through unimpaired capital, but also in maintenance of the "profits" of the enterprise, the corporate "surplus," in its popular connotation. Purchases of junior shares, normally the only voting shares and those catered to by management as its "electorate," diminish this protective fund available to senior shareholders as added protection for their liquidation rights, and also lessen the amounts available for payment of their admittedly prior dividend claims. Consequently, their consent to purchases of any junior shares should be required.

Moreover, even purchases of shares of their own class, if made at a premium and selectively, divert dividend funds from the unpurchased shareholders, and are discriminatory against them. It is, therefore, desirable for senior shareholders that offers to repurchase their shares, in addition to requiring approval by their own class, also necessitate pro rata offer, as an added protection against discrimination.

Even the junior voting shares, at the bottom of the bankruptcy deck, have the right to object to share purchases not carefully circumscribed. Purchases of shares senior to their own from either capital or surplus thereby diminish the fund available to them upon liquidation, and also the amount payable to them as dividends while the business continues. As was indicated previously, such share purchases can also disturb the voting balance in the corporation when voting shares are concerned. The best antidote to both corporate toxicants is approval by these voting shareholders and pro rata offer.

The junior class of shareholders often also has an interest in not having senior shares repurchased, even though they be redeemable. Although their re-acquisition eliminates an added dividend drain, repurchase of such shares at a "bonus" may lessen the dividend fund by more than even the long-range gain possible from having fewer shares out "over" the unpreferred. There may also be (for them) disastrous results in a faltering corporation where the last dregs of unrestricted assets are siphoned off to those in favor with the board of directors. Protection of the junior class demands as well that tender offers for all classes of shares have their approval, and be by pro rata offer, which latter minimizes the possibilities of favoritism, and hence injury to them.

An added safeguard is given by the proposed insolvency restrictions, since being the last to be "dealt a hand" on insolvency, they stand to lose the most, often their entire equity, on such an eventuality.
The preferable general rules are, consequently, simple and accord with the requirements of adequate protection for all persons involved. By imposing both the bankruptcy and equity insolvency restrictions on all share repurchases, and by limiting the general repurchases to actually earned surplus, thereby preventing not only a diminution of the asset fund below stated capital, but also circumvention of the latter restriction through its “loopholes” (either directly, by reducing the stated capital figure, or indirectly through retirement of repurchased shares or write-up of asset value), the interests of creditors and shareholders are both protected. The further limitation, that even if these requirements are met, share purchases must be by pro rata offer (or by lot), saves voting shareholders from vote dilution, and both voting and nonvoting shareholders from dividend dilution.

The additional requirement that share repurchases from any class have the approval of all classes of shareholders (two-thirds of the class from which repurchases are to be made plus two-thirds of each of the other classes, whether normally voting or nonvoting) follows from the interest which senior shareholders have in preventing injury to themselves through purchase of junior shares, and unfair purchases from their own class, and the interest which junior shareholders likewise have in preventing unfair purchases from their own junior class, and from classes senior to them.

The exceptions suggested (viz., good faith purchases from capital to pay off dissenters and to compromise indebtedness; repurchase from earned surplus, non-pro rata if with previous shareholder approval as part of employee share incentive plans, or close corporation restrictive shareholder agreements) coupled with a general grant (if similarly authorized) to repurchase a limited number of shares without any restriction (except good faith) should amply accommodate any present or prospective legitimate share repurchase needs of the third member of the trichotomy involved, the corporation itself.

Modern corporation laws, inheriting their defects from their progenitor, the Model Act, presently fail to give adequate protection to the interests of shareholders and creditors and, ultimately, the best interests of the corporation itself as a successful business vehicle. It is submitted that the legislators enacting these statutes did not really intend to slight any of these interests, and it is therefore hoped that they will soon correct their errors through statutes more adequate to the problem.

143. Including, of course, the extraordinary ones from capital. Compare Nemmers, supra note 108, at 193.

APPENDIX

PROPOSED STATUTORY PROVISIONS FOR REPURCHASES BY A CORPORATION OF ITS OWN SHARES

A. (I) No corporation shall purchase directly or indirectly any of its shares nor shall it agree to so repurchase, nor shall any contract to repurchase be enforceable if at the time of or as a result of such agreement or acquisition, or performance of said agreement, there is reasonable ground for believing

(1) That the corporation is or would be unable to meet its obligations as they become due in the ordinary course of business, or

(2) That the liabilities of the corporation do or would exceed the fair present value of its assets.

(II) Obligations incurred to any person or persons as a result of share acquisitions by any corporation organized under this statute shall take priority over any claims asserted by or in the right of shareholders of said corporation, but such obligations shall, except for evidences thereof in the form of negotiable instruments in the hands of holders in due course and without notice, be subordinated to the rights of all other creditors of the corporation.

B. Subject to the limitations of section A hereof, a corporation may purchase or redeem any of its shares from earned surplus, if all of the following conditions are also fulfilled:

(1) That two-thirds of all of the shareholders of each class, whether voting or non-voting, give their approval to said repurchases immediately prior to the making of the offer to repurchase by said corporation.

(2) That the offer to repurchase said shares be made pro rata to all shareholders of the class to be repurchased or that the shareholders to whom said offer shall be made be selected by lot, in a manner to be determined by the aforesaid vote of the aforesaid shareholders, after full disclosure to the said shareholders of the method proposed for making such selection.

(3) That if the shares to be repurchased are redeemable shares, no more than the redemption price thereof be paid.

C. Notwithstanding the limitations of subsection B, but subject to the limitations of subsection A hereof, a corporation may, if authorized by the vote, at least one year after the filing of the articles of incorporation of said corporation, of two-thirds of the shareholders of record of each class, whether said shareholders are voting or non-voting, enter into such contracts to purchase, or make such purchases of its shares, from earned surplus, as its board of directors may in good faith determine are desirable, provided that the sum total of the shares of any class held and which the corporation is obligated either absolutely or contingently to repurchase shall at no time exceed 5% of the outstanding shares of said class so repurchased or contracted to be repurchased.

D. Notwithstanding the other limitations of subsections B and C hereof but subject to the limitation of subsection A hereof, a corporation may, in good faith, and out of earned surplus, repurchase the shares of a shareholder whose shares it is obligated to repurchase under a shareholders' restrictive agreement to which all of its shareholders have assented and to which it is a party.

E. Notwithstanding the other limitations of subsections B and C hereof, but subject to the limitations of subsection A hereof, a corporation may purchase or reacquire its shares, from earned surplus, where it is granted the right so to do under an employee's incentive plan where such plan has been previously approved by two-thirds of the shareholders of each class of stock, whether voting or non-voting.

F. Notwithstanding the limitations of subsections B or C, but subject to the limitations of subsection A hereof, a corporation may, in good faith, and after first exhausting its earned surplus therefor, repurchase or otherwise reacquire its shares in order to:
(1) Compromise or collect any indebtedness due to the corporation, provided that said reacquisition does not involve directly or indirectly the payment of or obligation to pay any sums of money or the delivery of any property by the corporation.

(2) Pay dissenting shareholders entitled to appraisal under the provisions of this act no more than the amount to which they are entitled under the appraisal provisions of this act, upon satisfaction of the conditions thereof.

G. Notwithstanding any of the foregoing limitations, a corporation may, in good faith, reacquire its shares by gift or bequest.

H. Any shares reacquired pursuant to sections B, D, F or G hereof shall, if reoffered for sale, be first reoffered to the shareholders of the corporation in such manner as to preserve the voting rights and proportionate financial interest in said corporation of the shareholders of record at the time of said reoffer.

I. "Earned Surplus" as used herein shall mean the excess of the assets of the corporation over the sum of its liabilities, stated capital, and capital surplus, however created, including but without limitation thereto reduction surplus, surplus created by sale of par value shares at a consideration above par, surplus created by unrealized appreciation of assets, and allocations to surplus from the consideration received for no-par shares.

J. All directors and shareholders including former shareholders consenting to, or in any way participating in, any share reacquisitions, or payments, distributions or cancellations of obligations to the corporation as a result of such reacquisitions, whether or not the recipients of any benefit as a result of such reacquisitions, shall be jointly and severally liable to the corporation and its creditors in an amount equal to the value of any payment, distribution or cancellation of obligation resulting from any share reacquisition made, directly or indirectly, in violation of the provisions of this act.

(Special provisions with regard to investment companies might possibly also be added. See, e.g., N.C. Bus. Corp. Act § 55-52(b)(5).)