

THE PURCHASE BY A CORPORATION OF ITS  
OWN SHARES OF STOCK.—A SUGGESTED  
LEGISLATIVE APPROACH.

A corporate creation of shares of stock increases proportionately the number of dollars representing the corporation's "capital stock". From time to time corporations are parties to transactions which purport to reverse the process of creating shares by attempting to terminate the legal incidents connoted by the shares involved.<sup>1</sup> Generally such transactions involve either a "redemption" of shares or a "purchase" by the corporation of shares created by it. It is with the last mentioned practice that this article is concerned.

The right to redeem upon the payment of a stipulated amount by the corporation arises from an express provision in the certificate of incorporation and applies to all shares of the same class of stock. Generally, however, the right to purchase is independent of the certificate and does not obtain to all shares of a given class. It is not solely a contract right, emanating from a definite agreement between the shareholder and the corporation, for in periods of depressed and falling markets corporations with securities listed on the national exchanges have been known to enter the market for their own stock in an effort to stabilize violent price fluctuations. Such a practice has been justified.<sup>2</sup> However, the usual case presenting the problem deals with a contract made by the corporation with a shareholder wherein the latter agrees to sell and the former agrees to purchase, either presently or in the future, shares of the corporation's own stock.

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1. FREY, *CASES AND STATUTES ON BUSINESS ASSOCIATIONS* (1935), introduction to Chapter XI, "Distribution of Capital," p. 876.

2. BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) p. 175.

A general consideration of the problem of repurchase agreements reveals three judicial attitudes in the treatment thereof:

(1) A minority of courts in this country, absent express statutory or charter authority, view a contract made by a corporation for the purchase of shares of its own stock as *ultra vires* and unenforceable. From the point of view of comparative law this constitutes the "universal" rule;<sup>3</sup> it is accepted as sound by a majority of the text writers, and is supported by several strong opinions in its favor.<sup>4</sup>

(2) A majority of the courts have adopted a more "liberal" rule, ably stated by Judge Epes of the Virginia Supreme Court, in the course of a dissent from an opinion upholding an unconditional repurchase contract:<sup>5</sup>

"In the absence of statutory or charter authority or inhibition, a contract by a corporation to purchase its own stock will be upheld or enforced against the corporation provided: (1) That it is made in good faith without intent to injure creditors or stockholders who have not expressly or impliedly given their assent to or ratified the making of the contract; and provided (2) that at the time of performance compliance with the contract did not, or its enforcement will not, in fact, injure creditors or non-assenting stockholders."

(3) The third line of cases indicates that a contract for the repurchase of stock will be held enforceable, notwithstanding

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3. See Nussbaum, *Acquisition by a Corporation of its Own Stock*, (1935) 35 COLUMBIA LAW REV. 971. England, France, Canada, Germany, Switzerland and Italy have adopted this view.

4. See *e.g.* Judge Carpenter in *Crandall v. Lincoln*, 52 Conn. 73 (1884); Judge Learned Hand in *In re Tichenor v. Grand Co.*, 203 Fed. 720 (D.C., S.D.N.Y., 1913); Chief Justice Rand of Oregon in *Loveland Co. v. Doernbecher Mfg. Co.*, 39 Pac. (2d) 668 (Ore. 1934).

5. *Grace Securities Corp. v. Roberts*, 158 Va. 792, 164 S.E. 700 (1932).

the fact that the very purpose and necessary effect thereof was to give the stock involved a preference over the other stock of the corporation.

The New Jersey cases defy classification and demonstrate the need for a legislative definition of the corporate power to purchase, hold, sell and transfer shares of its own stock, together with necessary limitations on the scope of that power. The purpose of this article is to indicate the possible lines of approach to such legislation. The prime object to be kept in mind is the protection of creditors from shareholders and the protection of shareholders from one another by requiring the strict maintenance of what modern law calls "stated capital".

While much can be said in favor of the strict rule denying the corporate power to purchase its own shares,<sup>6</sup> situations are cognizable where such a power can be applied to the advantage of both creditors and stockholders. For example, the corporation should have power to purchase its own shares as a means of discharging a debt or effecting a compromise in order to prevent a loss, such as might be occasioned by a costly and troublesome law suit. In such situations, the treasury stock created will constitute an asset superior to the asset given in exchange by the corporation. The suggested legislation rather than deny the power in the first instance and then create permissible exceptions<sup>7</sup> should recognize the power in the first instance and then limit its scope by strict provisos.

Our present corporation act is silent on the question. The present power enjoyed by corporations of this state is an "im-

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6. It can be argued (persuasively), for example, that the concept of a corporation being its own shareholder is artificial in character and false to the basic theory of the corporate entity. See NUSSBAUM, *supra*, note 3, where it is stated, *inter alia*, that the acquisition by a corporation of its own stock is "unsound in its inception and productive of numerous and highly undesirable phenomena".

7. Such is the approach of many of the statutes in other states. See *e.g.* Section 342 of the California Civil Code ("A corporation may not purchase directly or indirectly any shares issued by it or by any corporation by which it is controlled, except as follows:").

plied power"<sup>8</sup> granted by the courts on the authority of those sections of the act making shares of stock personal property<sup>9</sup> and vesting the corporation with power to purchase such personal property as the purposes of the corporation shall require.<sup>10</sup> The danger of such an implication is apparent: No limitation is placed thereon, and it has been held by the court of errors and appeals that the power is as broad as the purchase of all other property.<sup>11</sup>

After recognizing the power, the suggested legislation should limit general purchases to those paid for out of *earned* surplus. This is another way of saying that shares may not be purchased out of paid-in stated capital or unearned surplus (paid-in surplus or capital surplus).

Stated capital is the basis of the share and financial structure of a corporation. It arises from the consideration received in payment for shares issued and from surplus funds capitalized by voluntary action by the board of directors or by the issuance of shares as a dividend,<sup>12</sup> and it stands as the only margin of security for the protection of both creditors and shareholders.<sup>13</sup> It is the only basis of credit of a corporation. Withdrawals therefrom by one class of shareholders to the prejudice of another class or to the detriment of creditors should, in no instance, be countenanced. This limitation on the corporate power to purchase its own shares would require the courts to

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8. Chapman v. Iron Clad Rheostat Co., 62 N.J.L. 497 (S. Ct. 1898); Berger v. U. S. Steel Corp., 63 N.J.Eq. 809, 53 Atl. 68 (E. & A. 1902).

9. Rev. St. 1938, 14:8-12.

10. Rev. St. 1937, 14:3-9.

11. Berger v. U. S. Steel Corp., *supra* note 8. ("... the company has power to buy its own shares and that power is given to it in the same terms and as broadly as the granted authority to purchase other personal property").

12. Hills, *The Model Corporation Act* (1935) 48 HARVARD LAW REV. 1334, 1335.

13. The term "stated capital" used herein is similar to the term "capital stock" used presently in the new Jersey Corporation Act. It is more descriptive and eliminates the confusion that has encircled the term "capital stock".

rigidly guard and protect the corporate credit base. It would be their duty to detect and defeat any scheme or device calculated in any way to place any portion of stated capital beyond the reach of creditors.

The prohibition against the purchase of shares out of *unearned* surplus is a further safeguard for creditors and shareholders. In the small corporation, having but one class of shares, all of which contributed equally to paid-in surplus, there is little objection to the purchase of shares from that source (provided, of course, that the purchase price and circumstances of purchase are fair to the other shareholders). On the other hand, the usual financial structure of the modern corporation, working with all possible permutations and combinations of the various legal incidents of shares, presents a staggering number of different classes of shares. The contributions of one class should not be used to purchase shares of another class. From the creditors' angle, paid-in surplus should not be accorded the same freedom as earned surplus. A recent survey of trends in modern corporate law indicates a pronounced restriction on the availability for withdrawal of paid-in surplus, which has come to be considered in many jurisdictions as "a semi-rigid amount which acts as a margin of net worth for the protection of stated capital in a manner similar to the protection of creditors by a fixed stated capital".<sup>14</sup> Thus, many of the state corporation acts restrict its availability for dividends, as well as for stock share purchases.<sup>15</sup>

By judicial limitation, share purchases in New Jersey have been limited to "surplus,"<sup>16</sup> with one case indicating that such surplus must be an available "free cash fund" and not that which is invested in corporate property.<sup>17</sup> There is no indication

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14. HILLS, *supra* note 12, at 48 HARVARD LAW REV. 1338.

15. See *e.g.* Minnesota Corporation Act, section 21, VI.

16. *Iback v. Elevator Supplies Co., Inc.*, 118 N.J.Eq. 90, 177 Atl. 458 (Ch. 1925).

17. *Hoops v. Leddy*, 119 N.J.Eq. 296, 182 Atl. 271 (Ch. 1936).

that our courts would recognize a distinction between earned and unearned surplus; and, as both dividends and share purchases effect a distribution of surplus funds, an argument, based on the statutory allowance of dividends from unearned surplus,<sup>18</sup> that no such distinction should be made might prevail. The legislative limitation herein suggested would prevent such an argument from becoming the law.

The suggested statute, however, should recognize that under certain specific conditions purchases out of stated capital and any surplus or out of any surplus alone are necessarily desirable. It is generally accepted that shares having a distribution preference are entitled to greater latitude than common shares; their purchase out of stated capital is to be expected as "a normal financial operation,"<sup>19</sup> provided that they are thereafter treated as authorized but unissued shares. Upon a resale or a reissue, the consideration received would be allocated to stated capital or to stated capital and paid in surplus. The issue, the purchase, and the restoration to authorized but unissued shares, constitutes "a complete cycle".<sup>20</sup> The purchase of shares having a distribution preference out of stated capital or any surplus should be made permissible in the suggested legislation.

Likewise, provision should be made for the purchase of any shares out of *any* surplus if the object of the purchase is to collect or compromise a debt, claim or controversy. The settlement of claims by or against corporations should be facilitated. There is little opportunity for abuse here, for the shares acquired, generally, will constitute a superior and more definite asset than the consideration paid by the corporation. Likewise, purchases seeking the elimination or adjustment of fractional shares and the discharge of obligations to shareholders who

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18. Rev. St. 1937, 14:8-6.

19. HILLS, *supra*, note 12, at 48 HARVARD LAW REV. 1340.

20. *Ibidem*.

have exercised a right of dissent from corporate action should not be rendered impossible by the lack of surplus. Purchases seeking the accomplishment of these ends should be allowed out of any surplus or stated capital. In the case of fractional shares, there will be no substantial effect upon the corporate structure; in the case of the dissenting shareholder, his right of dissent, accompanied by a further right to a valuation and purchase of his shares, is of fundamental importance and the purchase out of capital or surplus gives it a practical value.

The first section of the proposed legislation, then, should recognize the corporation's right to purchase its own shares, but should limit this right to purchases out of earned surplus, with stated exceptions seeking the accomplishment of specific purposes under circumstances susceptible to but little abuse. The second section of the suggested act should consider the effect of such purchases on the corporate financial position.

Under no circumstances should a purchase be permitted if at the time of the purchase, or before the consummation thereof, the corporation is insolvent, or if it would render the corporation insolvent or unable to satisfy its debts and liabilities, determined or contingent. The present state of the law on this point in New Jersey is somewhat confusing. An analysis of the cases, therefore, is justifiable.

In 1919, Vice-Chancellor Lane held unenforceable a repurchase agreement entered into at a time when the corporation was insolvent.<sup>21</sup> That he intended the decision to go beyond the precise factual situation presented is evident on a close reading of the opinion and the authorities therein cited. The main point was not that insolvency was present at the time the contract was made, but that the corporation was insolvent at the time the agreement was sought to be enforced. The language of the

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21. *Hoover Steel Ball Co. v. Schaefer Ball Bearing Co.*, 90 N.J.Eq. 164, 106 Atl. 471 (Ch. 1919).

opinion would appear to be susceptible to but one interpretation:

"If a purchaser of, or a subscriber to, stock may contract with the corporation that it shall repurchase the stock, then every purchaser or subscriber may do likewise, and if these contracts may be enforced after insolvency, then not only will creditors be deprived of recourse to the capital stock as a trust fund,<sup>22</sup> but the apparent purchasers and subscribers will be converted into creditors to share with other creditors whatever assets there may be left. Such a situation is, of course, opposed to public policy and cannot be permitted to exist."

Prior to this decision, Vice-Chancellor Stevens had expressed a strong doubt that the implied power to purchase, granted by the *Berger* case,<sup>23</sup> went the length of authorizing a corporation to purchase and pay for its own stock if to do so would disable it from paying its debts in full or convert a shareholder into a creditor entitled to share equally with other creditors. This limitation on the rule of the *Berger* case was approved in two instances by the court of errors and appeals.<sup>24</sup>

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22. The author disagrees with the theory that "capital stock" is to be treated as a "trust fund". Discussion of this problem is only slightly relevant here; it will suffice to say that Mr. Justice Story's trust fund theory of maintaining corporate capital has been found to be little more than a name. See Warren, *Safeguarding the Creditors of Corporations* (1923) 36 HARVARD LAW REV. 509. There is danger in permanent capital being guided by day-to-day valuations; thus, it should be treated as a *quantum*, a marginal amount which must be in existence and maintained as a condition precedent to the withdrawal of assets to shareholders, rather than a *res*. See Isaacs, *Principal—Quantum or Res* (1933), 46 HARVARD LAW REV. 776. Cf. *Wetherbee v. Baker*, 35 N.J.Eq. 501 (E. & A. 1882).

23. *Berger v. U. S. Steel Corp.*, *supra*, note 8.

24. *Knickerbocker Importation Co. v. State Board*, 74 N.J.L. 583, 65 Atl. 913, 7 L.R.A. (N. S.) 885 (E. & A. 1906); *Beach v. Palisades Realty & Amusement Co.*, 86 N.J.L. 238, 90 Atl. 1118 (E. & A. 1914).

It thus appeared "well settled" that insolvency or a liquidity diminishing below the aggregate of outstanding creditor obligations would defeat the right of a corporation to acquire its own shares by purchase.

However, in *Wolff v. Heidritter Lumber Co.*,<sup>25</sup> it was held that if the corporation was solvent at the time a repurchase contract was entered into, subsequent insolvency and the appointment of a receiver would not defeat performance of the agreement, provided the transaction was for the accomplishment of "a legitimate corporate purpose". Here the contract called for an immediate repurchase, with payment in quarterly installments spread over a period of more than ten years. At the time of insolvency less than half the purchase price had been paid, and the court allowed the shareholder, *as a creditor*, to file a claim with the receiver for the balance due (with interest).

The decision lends itself to criticism both from a standpoint of precedent and reason. It is directly contrary to an unreported case<sup>26</sup> decided by Vice-Chancellor Foster and referred to in the *Hoover*<sup>27</sup> case. There an appeal was taken from a determination of a receiver disallowing a claim filed by an employe who had agreed to buy stock under a repurchase agreement to take effect upon the termination of his employment with the corporation. The employe, upon severing his relations with the defendant, served notice that he desired to have his stock repurchased, but took no further action until after the company was adjudged insolvent more than a year later. The Vice-Chancellor sustained the action of the receiver on the ground that "the allowance of the claim would result in preventing the property of the corporation being used to pay its legitimate debts in full and would

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25. 112 N.J.Eq. 34, 163 Atl. 140 (Ch. 1932). Noted in 18 CORNELL LAW Q. 589 (1933) and 42 YALE LAW J. 1128 (1933).

26. *Bayne v. Coming Egg Farm*, decided May 18th, 1918 (Ch.).

27. *Hoover Steel Ball Co. v. Schaefer Ball Bearing Co.*, *supra*, note 21.

convert such a stockholder into a creditor of the company and thus enable him to participate equally with other creditors in the distribution of assets and would increase the amount of the company's liabilities over its assets to such an extent as that the claims of actual creditors would not be paid in full."<sup>28</sup>

The attempt of the court in the *Wolff* case to distinguish Vice-Chancellor Lane's earlier opinion on the ground that the contract in the former case was "a presently operative purchase," while in the latter it was "an executory contract to purchase *in futuro*" seems highly legalistic, in view of the fact that the agreement in the *Wolff* case was far from consummated at the time of insolvency. If a stockholder sells his stock to the corporation which issued it, he should be held to do so at his peril and assume the risk of the consummation of the transaction without encroachment upon the funds which belong to the corporation for the payment of its creditors.<sup>29</sup>

The implications of the *Wolff* case are undesirable both from the standpoint of other shareholders and creditors. By allowing the vendor-stockholder to achieve the status of a creditor, the equitable rights of other stockholders are prejudiced. Generally, shareholders become such on a representation that the rights of all holders of the same class are equal and that the corporation will maintain the status of equality. If the corporation enters into an agreement with some of its shareholders whereby it contracts to repurchase their stock, without the knowledge and consent of the remaining shareholders, the effect is to destroy that equality which the stockholders have an equitable right to have maintained, since it affords some the right to convert themselves into creditors and their stock into cash and deny the same right to others.<sup>30</sup> Under the factual situation of

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28. The quotation is contained in the text of the decision in the *Hoover* case, *supra*, note 21.

29. Such is the rule of the federal courts. See *In re Fechheimer Fishel Co.*, 212 Fed. 357 (C.C. 2d., 1914).

30. *Hoops v. Leddy*, 119 N.J.Eq. 296, 182 Atl. 271 (Ch. 1936).

the *Wolff* case, one shareholder is allowed to participate in the distribution of remaining assets, while the others go begging. From the creditors' angle, the *Wolff* case disturbs the seniority of creditors by withdrawing assets upon which the legitimate creditors have relied and are deemed to possess a superior right or lien. The prior provision of the suggested legislation which allows a purchase out of earned surplus alone, coupled with the present suggestion, would prevent a result such as that reached by the *Wolff* decision. Payment out of capital, or any withdrawal by a shareholder must not be made to the prejudice of creditors.

To enforce the provisions of the suggested legislation and to deter temptations to act contrary to its prohibitions, violations should be made a misdemeanor. Experience has shown that civil redress is not sufficient to secure observance of the law.<sup>31</sup> The threat of indictment, rather than actual prosecution, can be used effectively, as the current federal anti-trust campaign demonstrates. Such a provision would conform to the more modern statutes in other jurisdictions.<sup>32</sup>

Further additional provisions might be considered. To safeguard against fraud, repurchase contracts should be in writing. The present case law permits an oral agreement to be introduced.<sup>33</sup> Treasury shares should not be allowed voting, dividend or distribution rights. Nor, for the purposes of bookkeeping, should they be considered and carried as an asset on the balance sheet.<sup>34</sup> This latter prohibition necessarily follows from

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31. See NUSSEBAUM, *supra*, note 3.

32. See *e.g.* New York Penal Law, sec. 664 (5), making it a misdemeanor "to apply any portion of the funds of such corporation, except surplus profits, directly or indirectly, to the purchase of shares of its own stock". *Cf.* Rev. St. 1937, 54:11-13, making it a misdemeanor to act under a voided charter.

33. *Downs v. Jersey Central Power & Light Co.*, 115 N.J.Eq. 348, 170 Atl. 835 (Ch. 1934), *aff'd* in 117 N.J.Eq. 138, 174 Atl. 887 (E. & A. 1935).

34. See HILLS, *supra*, note 12, at 48 HARVARD LAW REV. 1342: "A further attempt by modern law to correct abuses of the past is found in the prohibition that treasury shares shall not be carried as an asset. Two practices sanctioned by

the requirement that such shares be purchased only from surplus.

That further provisions might be necessary is not denied. The writer has merely attempted to indicate the more general lines of approach to the development of a field in corporate law which, despite a statutory appearance of fixity, is in a state of flux and unrest.<sup>35</sup>

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the accounting profession and established by years of usage are in direct conflict with the legal requisites of stated capital. These practices are to carry treasury shares on the balance sheet as an asset (sometimes as a current asset), or as a deduction from stated capital. To carry common shares or other shares not purchaseable or redeemable out of stated capital as an asset is (a) to vitiate the requirement that such shares be purchased only from surplus or (b) to evade the prohibition against purchasing shares out of stated capital in case the purchase price of such shares exceeds the available surplus; and to carry preferred shares purchaseable or redeemable out of stated capital as an asset is to fail to disclose a payment out of stated capital, if the purchase price was actually taken therefrom. To carry shares of any class as an apparent deduction from stated capital is necessarily (a) a misrepresentation that surplus has not been reduced, or (b) in case there is not sufficient surplus to absorb the reduction, an admission of an illegal reduction of stated capital, or (c) a representation that stated capital has been legally reduced."

35. Indications of changes in general attitudes toward fundamental problems of modern corporation law are well brought out in Rohrllick, *The New Deal in Corporation Law* (1935) 35 COLUMBIA LAW REV. 1167. See also the "Model Corporation Act" drafted and proposed by George S. Hills, Esq., of the New York Bar, a scholarly incorporation of sound principles and trends in the modern law of corporations, note 12, *supra*.