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PURCHASE AND REDEMPTION BY A CORPORATION OF ITS OWN SHARES: THE SUBSTANTIVE LAW

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The view taken by the majority of American courts that, in the absence of restrictive statutory provisions, a solvent corporation may lawfully purchase its own shares out of capital has been justly and severely criticized in treatises¹ and law reviews² for two generations. The dangers which are involved in purchases out of capital, and to an only slightly less extent in purchases out of "capital" surplus, are obvious enough. Such purchases impair the creditors' margin of safety, an objection which has peculiar force in those cases in which there are debenture holders or other long-term creditors whose risk is a continuing one. If there are outstanding preferred shares, such purchases impair the preferred shareholders' margin of safety—and preferred shareholders, unlike most creditors, are long-term investors in corporate enterprises. Even if all of the issued shares are common shares, purchase out of capital reduces, temporarily or permanently, the assets which are devoted and which the shareholders had reason to expect would be devoted to the prosecution of the business.

Such purchases are likely to be used to enable influential insiders to withdraw from shaky corporations. They are likely to be used to

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1. MORAWETZ, *PRIVATE CORPORATIONS* (2d ed. 1886) §§ 112, 113; 1 MACHEN, *MODERN LAW OF CORPORATIONS* (1908) §§ 626 *et seq.*

2. Nussbaum, *Acquisition by a Corporation of Its Own Stock* (1935) 35 *COL. L. REV.* 970; Levy, *Purchase by a Corporation of Its Own Stock* (1930) 15 *MINN. L. REV.* 1; Glenn, *Treasury Stock* (1929) 15 *VA. L. REV.* 625. See also Ballantine, *Questions of Policy in Drafting a Modern Corporation Law* (1931) 19 *CALIF. L. REV.* 465, 479. *But cf.* Wormser, *The Power of a Corporation to Acquire Its Own Stock* (1915) 24 *YALE L. J.* 177.

buy off shareholder-opponents of the management without regard to whether their opposition is beneficial or harmful to the corporation. If the shares are listed on an exchange, such purchases are likely to be made for purposes of market speculation or even of market manipulation.³ Although some of these dangerous potentialities are not confined to purchases out of capital or unearned surplus, the objections to purchases of those types are so numerous and so serious that legal writers almost without exception have agreed that such purchases, at least, should be prohibited.

The question is one which no longer needs extended discussion, at least so far as the problem relates to capital in the strict sense as distinguished from capital surplus. We shall, therefore, take it for granted in what follows that the rule is a bad one. It has so few defenders, other than the wearers of judicial robes, that practically all the statutes which deal with the question at all, including those enacted in what are sometimes unkindly referred to as the "charter-mongering" states, reject it. We can with more profit devote our attention to other questions. How did the rule arise? What is its scope in those jurisdictions which adhere to it? To what extent has it been modified by modern corporation statutes both as to ordinary purchases and as to those which are made pursuant to special terms in the original subscription, and what are the sanctions by which currently existing statutory restrictions are enforceable? To what extent are there, or should there be, legal differences between such purchases and the redemption or purchase of shares which are redeemable by virtue of provisions in the corporation's charter?

I. PURCHASE OF SHARES

Origin and Development of the So-Called American Rule

The question when, if at all, a corporation may lawfully purchase its own shares is one on which American authority developed very slowly. The earliest expression of judicial opinion on the subject seems to be the dictum in the case of *Ex parte Holmes*,⁴ decided by the Supreme Court of New York in 1826, to the effect that a corporation may take its own shares in payment of a debt due to it. This case was followed by some inconclusive remarks on the subject by the Vice-Chancellor some five years later,⁵ and by a vigorously expressed dis-

3. For a study of purchases of shares by investment companies and the abuses to which such purchases have led, see REP. S. E. C., *Investment Trusts and Investment Companies*, Pt. II, 236 *et seq.*, Pt. III, c. III, 211 *et seq.* For a study of the results of purchases of shares by eighty large corporations during the period immediately prior to federal regulation of the security markets, see Holt and Morris, *Some Aspects of Reacquired Treasury Shares, 1931-1933* (1934) 12 HARV. BUS. REV. 505.

4. 5 Cow. 426, 434-5 (N. Y. Sup. Ct. 1826).

5. *Verplank v. Mercantile Ins. Co.*, 1 Edw. Ch. 84, 94 (N. Y. 1831).

approval of an ordinary agreement to purchase by the same Supreme Court in *Barton v. Port Jackson*,⁶ decided in 1854. Four years later the New York tide turned as a result of a statement in an opinion by Selden, J., in the New York Court of Appeals that he was not aware of any common law principle which forbade a corporation to buy its own shares. This statement subsequently came to be regarded, both in New York and elsewhere, as aligning that important jurisdiction with the view that, subject to some ill-defined limitations, the purchase by a corporation of its own shares is a legitimate corporate act.⁷

During the period in which the New York courts were handing down these opinions, the question was also being dealt with to a slight extent in a number of other jurisdictions. The most significant of these early cases are: *Hartridge v. Rockwell*,⁸ in which, in holding that shares purchased by a corporation could be resold, the court expressed the opinion that the purchase was legally unobjectionable; *Percy v. Millaudon*,⁹ in which directors of a bank who had sold their shares to it were compelled to refund the purchase price at suit of a shareholder, the court saying that the purchase reduced the capital and in consequence injured the creditors, the shareholders and the general public; and *Taylor v. Miami Exporting Co.*,¹⁰ in which the court, in a case involving merely the taking of shares in payment of a debt, used broad language in support of the existence of a general right to purchase.¹¹

A few favorable¹² and unfavorable dicta¹³ uttered during the next forty years were finally followed by what seems to have been the first square decision in favor of the power to purchase, that of the Massachusetts court in *Dupee v. Boston Water Power Co.*¹⁴ In that case the court dismissed a bill for an injunction brought by a shareholder against his company, which was engaged in filling and grading tide-flowed lands in order to sell them in lots, and which had offered to accept its own shares in payment of one-half of the purchase price of each lot of land sold. During the same decade, the courts of Illi-

6. 17 Barb. 397 (N. Y. Sup. Ct. 1854).

7. *City Bank of Columbia v. Bruce & Fox*, 17 N. Y. 507, 511 (1858), relating to an Ohio banking corporation.

8. *R. M. Charlton* 260 (Ga. Super. Ct. 1828).

9. 3 La. 568 (1832).

10. 6 Ohio 176 (1833).

11. A few other early cases upheld acquisition by the corporation in payment of a debt. *Williams v. Savage Mfg. Co.*, 3 Md. Ch. 418 (1851); *State Bank of Ohio v. Fox*, 5 Fed. Cas. 632, No. 2683 (C. C. N. D. N. Y. 1856). In *Farmers' and Mechanics' Bank v. Champlain Trans. Co.*, 18 Vt. 131 (1846) it was held that one who had sold his shares in a bank to it was no longer a shareholder and hence was not disqualified from testifying in an action to which it was a party.

12. *American Railway-Frog Co. v. Haven*, 101 Mass. 398, 402 (1869); *Leland v. Hayden*, 102 Mass. 542, 551 (1869).

13. *Coleman v. Columbia Oil Co.*, 51 Pac. 74 (1865). See also *Bedford R. R. v. Bowser*, 48 Pa. 29 (1864).

14. 114 Mass. 37 (1873).

nois¹⁵ and Iowa¹⁶ took the position that an agreement by a corporation to purchase its own shares was valid and binding on it. On the other hand, the courts of New Hampshire¹⁷ and Kansas¹⁸ held that such purchases were rescindable by the corporation, so that the numerical weight of the decisions during the ten-year period was only slightly in favor of the laxer view.

The period from 1880 to 1890 brought about a temporary turning of the tide with a decision by the Ohio court¹⁹ limiting the scope of its previous decision to cases in which the shares were taken in payment of a debt; one by the Illinois court²⁰ holding that its earlier decision in favor of the power to purchase did not mean that the purchase could not be impeached by a creditor where the payment was made out of capital and the corporation later became insolvent; and one by the Connecticut court²¹ holding that purchases made by a corporation whose capital was impaired could be rescinded by a subsequently-appointed receiver. The few contemporary cases in which corporate purchases were more favorably regarded are unimpressive,²² and the restrictive view received at this time powerful support from the House of Lords²³ and from Morawetz.²⁴

Although one who studied the American law of fifty years ago might have hesitated to predict that the full rigor of the English view, according to which such purchases were *ultra vires*, would generally prevail in this country, he might reasonably have hazarded the opinion that few, if any, American courts would sustain such purchases against attack by unpaid creditors, at least where the purchase involved the depletion of corporate capital. Nevertheless, the subsequent development of American case law in the majority of jurisdictions has not been very favorable to creditors. It is true that, since 1890, several additional jurisdictions have, with little or no aid from statutes, denied or greatly restricted a corporation's power to purchase its own shares.²⁵

15. *Chicago, Pekin & South Western R. R. v. Marseilles*, 84 Ill. 145 (1876), *aff'd on rehearing*, 84 Ill. 643 (1877).

16. *Iowa Lumber Co. v. Foster*, 49 Iowa 25 (1878). *Cf. State ex rel. Page v. Smith*, 48 Vt. 266 (1876).

17. *Currier v. Slate Co.*, 56 N. H. 262 (1875).

18. *German Savings Bank v. Wulfekuhler*, 19 Kan. 60 (1877), relying to some extent on a statute providing for liability of shareholders for corporate debts to an amount equal to the par value of their shares.

19. *Coppin v. Greenless & Ransome Co.*, 38 Ohio St. 275 (1882).

20. *Clapp v. Peterson*, 104 Ill. 26 (1882).

21. *Crandall, Receiver v. Lincoln*, 52 Conn. 73 (1884).

22. *See, e. g., Vail v. Hamilton*, 85 N. Y. 453, 457 (1881), containing a dictum in favor of the power to purchase.

23. *Trevor v. Whitworth*, 12 A. C. 409 (H. L. 1887).

24. MORAWETZ, *PRIVATE CORPORATIONS* (1st ed. 1882) §§ 230, 231; (2d ed. 1886) §§ 112, 113.

25. *See, e. g., Maryland Trust Co. v. National Mechanics Bank*, 102 Md. 608, 65 Atl. 70 (1906); *Cartwright v. Dickinson*, 88 Tenn. 476, 12 S. W. 1030 (1890).

In some jurisdictions, decisions denying the existence of corporate power to buy shares, at least where the purchase is made out of capital, have been influenced by

But during the period between 1890 and the beginning of the movement for modernization of corporation statutes which became active about the year 1927, a substantially larger number of courts joined the ranks of those who saw nothing improper in a corporation's use of its capital for the purchase of its own shares.²⁶

A number of factors contributed to this result. The prestige of those American courts which had, as early as 1890, by language or decision given their approval to such purchases, at least in cases in which the rights of creditors were not directly at issue, was somewhat greater than that of the courts which had adopted a stricter view. Furthermore, much of the litigation, both before and after that date, involved the validity not of the purchase but of the reissue of the purchased shares, and casual statements in opinions dealing with the latter question to the effect that the original purchase was valid were sometimes taken at their face value without regard to the context in which they were found. Finally, and perhaps most important, it continued to be true for a good many years after 1890 that even the cases in which the validity of the purchase was directly at issue were, with rare exceptions, cases to which neither creditors nor representatives of creditors were parties.

When such cases did arise, even the courts which had sustained the power to make purchases out of capital did not completely ignore the rights of creditors. Persons whose shares the corporation had promised to purchase were generally denied the right to enforce that promise or security given for it in competition with its other creditors if the corporation was insolvent when the promise was made or became so prior to performance.²⁷ One or two courts, however, per-

statutes prohibiting directors from dividing, withdrawing, or paying to shareholders or any of them, any part of the capital stock, or from reducing the capital except as provided by law. See *Schulte v. Boulevard Gardens Land Co.*, 164 Cal. 464, 468, 129 Pac. 582, 583 (1913); *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 Pac. 1155 (1913).

For the statutes now in effect in California, Maryland and Tennessee, see notes 39, 40 and 41, *infra*.

26. See, e. g., *Copper Belle Min. Co. v. Costello*, 11 Ariz. 334, 95 Pac. 94 (1908), *rehearing denied*, 12 Ariz. 105, 95 Pac. 803 (1908); *Cole v. Cole Realty Co.*, 169 Mich. 347, 135 N. W. 329 (1912); *Gipson v. Bedard*, 173 Minn. 104, 217 N. W. 139 (1927); *Fremont Carriage Mfg. Co. v. Thomsen*, 65 Neb. 370, 91 N. W. 376 (1902); *Chapman v. Iron Clad Rheostat Co.*, 62 N. J. L. 497, 41 Atl. 690 (Sup. Ct. 1898); *Blalock v. Kernersville Mfg. Co.*, 110 N. C. 99, 14 S. E. 501 (1891); *Shoemaker v. Washburn Lumber Co.*, 97 Wis. 585, 73 N. W. 333 (1897).

For the statutes now in effect in Michigan and Minnesota, see notes 40 and 41, *infra*.

Prior to the enactment of the Business Corporation Act of 1933, PA. STAT. ANN. (Purdon, 1938) tit. 15, §2852, the Pennsylvania decisions were in accord with the majority view, at least in cases in which the repurchase agreement was a term of the original subscription. *Smith v. Citizens Ins. & Mfg. Co.*, 284 Pa. 380, 131 Atl. 191 (1925); *Wolf v. Excelsior, etc., Co.*, 270 Pa. 548, 113 Atl. 569 (1921); *Illoway v. Daly*, 65 Pa. Super. 333 (1916). See also PA. STAT. ANN. (Purdon, 1938) tit. 15, §662, repealed as to business corporations by the Act of 1933.

27. *Boggs v. Fleming*, 66 F. (2d) 859 (C. C. A. 4th, 1933); *Coleman v. Tepel*, 230 Fed. 63 (C. C. A. 3d, 1916) (in which the corporation gave a bond and mortgage for

mitted the shareholder even then to compete with subsequent creditors who had notice of the agreement at the time when they extended credit.²⁸

In several cases, the further step was taken of holding that a payment made by an insolvent corporation as the purchase price of its own shares may be recovered by or for creditors.²⁹ Where the entire transaction takes place when the corporation is insolvent, payment for the worthless shares is indubitably a fraudulent conveyance of the assets which are used to make the payment. The result should not be different where an executory contract to purchase its own shares, which was made by a then solvent corporation, has been performed after insolvency. If the corporation should expressly stipulate that it would perform its agreement to purchase its own shares regardless of whether it continued to be solvent on the date of performance, such an agreement should be held illegal. An agreement to purchase in the future should, therefore, be treated as an agreement to purchase if, but only if, the corporation remains solvent.³⁰ There is, however, at least one case which expresses doubt as to the right of subsequent creditors to attack such a purchase even though the corporation was, at the time of the purchase, insolvent in the sense of being unable to pay its debts as they accrued, and there was no evidence that these creditors extended credit with knowledge of the purchase.³¹

its shares and was immediately rendered insolvent thereby); *Commercial National Bank v. Burch*, 141 Ill. 519, 31 N. E. 420 (1892); *Barden v. A. Heller Sawdust Co.*, 240 Mich. 549, 216 N. W. 464 (1927).

Many of the cases involve agreements made at the time of the original subscription. See, e. g., *White v. Lorimer's City Dye Works*, 46 Idaho 490, 269 Pac. 906 (1928); *McIntyre v. E. Bement's Sons*, 146 Mich. 74, 109 N. W. 45 (1906) (decision based in part on a statute); *Hoover Steel Ball Co. v. Schaeffer Ball Bearings Co.*, 90 N. J. Eq. 164, 106 Atl. 471 (Ch. 1919) (involving a corporation governed by the New York statute, but stating that the same result would be reached under the non-statutory law of New Jersey).

28. *First Trust Co. v. Illinois Central Ry.*, 256 Fed. 830 (C. C. A. 8th, 1919) (mortgage given by an insolvent railroad to secure bonds issued in exchange for its shares held valid as against subsequent creditors having constructive notice from the record of the mortgage). *But cf. Loveland v. Doernbecher Mfg. Co.*, 149 Ore. 58, 39 P. (2d) 668 (1934), in which the court, in dismissing a bill brought by a subsequent creditor with knowledge for an injunction against the use of capital to pay an installment due on a contract to purchase its own shares, said that a different question would arise if the payment of any future installment should make the corporation insolvent.

29. *Fitzpatrick v. McGregor*, 133 Ga. 332, 65 S. E. 859 (1909). See also cases cited in note 31, *infra*.

30. Where a statute forbids purchase of shares except out of surplus, a contract for the future purchase of shares has been construed as a contract to purchase shares if the corporation had a surplus at the date of performance. *Richards v. Wiener Co.*, 207 N. Y. 59, 100 N. E. 592 (1912).

31. *Marvin v. Anderson*, 111 Wis. 387, 87 N. W. 226 (1901). The decision, however, rested primarily on the holding that insolvency does not mean mere temporary inability to pay debts, but that the liabilities are in excess of the fair cash value of the assets. It was followed, as to this definition of insolvency, in *Gipson v. Bedard*, 173 Minn. 104, 217 N. W. 139 (1927). *But cf. Joseph, Trustee v. Raff*, 82 App. Div. 47, 81 N. Y. Supp. 546 (1st Dep't 1903), *aff'd mem.*, 176 N. Y. 611, 68 N. E. 1118 (1903).

For a decision sustaining the right of subsequent creditors to recover even where the purchase merely impaired capital and the corporation did not become bankrupt until

Several courts which treat a purchase by a corporation of its own shares, made out of capital, as valid between the parties, have held that, if the transaction was completed while the corporation was still solvent, it cannot subsequently be set aside by or for creditors, even though the corporation later becomes insolvent.³² A court which has already committed itself to the proposition that a corporation may make a binding contract to purchase its own shares out of capital may well shrink from holding that the performance of such an agreement, which is the legal duty of the parties as between themselves, subjects one of them to the risk of future liability to creditors.³³ It will be particularly reluctant to reach such a result in a case where the only creditors involved are subsequent creditors.³⁴ The purchase, which does not produce insolvency but merely impairment of capital, is not a fraudulent conveyance even if the incurring of future debts was contemplated. If all prior creditors are paid, the transaction cannot be looked upon as legally objectionable unless one takes a strong line against the propriety of purchases that impair capital, a line which is hardly consistent with the court's previously expressed views as to the power of the corporation to employ its capital in the purchase of its shares.

Decisions refusing to require restitution under these circumstances are a natural, even if they are not an inevitable, consequence of holding that an agreement to purchase shares out of capital is valid between the parties. On the other hand, a recent Massachusetts decision,³⁵ which goes to even greater lengths in upholding a repurchase agreement as against a creditor, involves an unnecessary and wholly undesirable

more than two years later, see *Union Trust Co. v. Amery*, 67 Wash. 1, 120 Pac. 539 (1912), in which the court relied on a statute requiring a public record of capital reduction.

Even in Wisconsin, subsequent creditors have been allowed to avoid a purchase of shares where the shareholder knew that it was contemplated that the corporation, which was made insolvent by the purchase, would remain in business and incur future debts. *Walworth B. & C. Ass'n v. Smith*, 141 Wis. 377, 123 N. W. 106 (1910); *accord*, *Johnson v. Canfield Swigert Co.*, 292 Ill. 101, 126 N. E. 608 (1920); *cf.* *Coleman v. Tepel*, 230 Fed. 63 (C. C. A. 3d, 1916), cited note 27, *supra*.

32. *Thompson v. Shepherd*, 203 N. C. 310, 165 S. E. 796 (1932); *Marvin v. Anderson*, 111 Wis. 387, 87 N. W. 226 (1901), cited note 31, *supra*. In the second case, the corporation, at the time of the purchase, was solvent in the bankruptcy sense although unable to pay its debts as they matured. Recovery of the purchase price by the corporation's trustee in bankruptcy was refused. The court adverted to the fact that all the creditors were subsequent creditors, but did not rest the case primarily on that ground.

33. The Virginia court, which has consistently upheld purchases out of capital in cases where no creditor was objecting, has, however, recently held that one who was a creditor at the time when the corporation purchased its share out of capital can compel a refund of the purchase price if the corporation later becomes insolvent. *Marshall v. Fredericksburg Lumber Co.*, 162 Va. 136, 173 S. E. 553 (1934); *cf.* *Williams v. Brownstein*, 1 F. (2d) 470 (D. D. Me. 1924).

34. For a case in which recovery of the purchase price from one who had sold his shares to a corporation prior to its insolvency was denied solely on the ground that subsequent creditors are not entitled to relief, see *Kaminsky v. Phinizy*, 54 F. (2d) 16 (C. C. A. 5th, 1931).

35. *Scriggins v. Thomas Dalby Co.*, 290 Mass. 414, 195 N. E. 749 (1935).

extension of the American rule. A creditor of a corporation, which was admittedly unable to pay its debts as they accrued, and probably unable to pay them at all, sought by a bill in equity to enjoin an action at law brought by a shareholder to enforce the corporation's promise to buy his shares. Although the corporation's promise was evidenced by promissory notes, the plaintiff in the law action had not surrendered his share certificates but had deposited them in escrow with a bank. The court denied relief on the basis of findings that the corporation was solvent when the contract was made and that, although its financial condition became rather steadily worse thereafter, it was still solvent at the time when the action was brought. It is difficult to see anything in those facts which should so paralyze the arm of equity as to prevent it from aiding a creditor to obtain that to which he is entitled by a fundamental rule of corporation law. The assets of an insolvent corporation should be applied to the claims of its creditors in priority to the claim of one who, despite his possession of the corporation's notes, is still clinging to his shareholder status.³⁶

Modern Statutes Relating to Purchase

A rule which leads courts to reach results such as that arrived at in the case last cited does not belong in any enlightened system of jurisprudence. Fortunately, statutes have now been enacted in most of the leading corporation states which substantially restrict a corporation's power to purchase its own shares. Although a few of these statutes notably those of New York³⁷ and Delaware,³⁸ are of earlier origin, most of them have been passed during the last fifteen years as part of a general movement to codify and modernize the statutory law of business corporations. The majority of these statutes, in addition to permitting the purchase of shares out of capital in certain special situations,³⁹ give the corporation, and by inference the management,

36. The fact that the plaintiff became a creditor after the contract of purchase was made and with knowledge of it was mentioned by the court, but not relied on as a ground of decision. It should be irrelevant, since knowledge that the contract exists is not assent to its enforcement under radically altered conditions.

37. NEW YORK PENAL LAW, § 664. This section makes it a misdemeanor for a director of a stock corporation "to apply any funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock."

This section is derived from the Penal Code of 1881, § 594, which differed from the present act only by containing the word "profits" after the word "surplus".

38. DEL. REV. CODE (1935) c. 65, § 19. The section was originally enacted in its present form by L. 1909, c. 154.

39. See, e. g., CAL. CIV. CODE (Deering, 1937) § 342, which permits purchase from stated capital or unearned surplus for the purpose of collecting or compromising a debt or claim, satisfying appraisal rights of dissenting shareholders in case of merger or consolidation, carrying out a repurchase agreement made with an employee-subscriber at the time of subscribing, eliminating fractional shares, redeeming or purchasing shares which are subject to redemption, carrying out conversion provisions contained in the articles of incorporation, and distributing surplus resulting from capital reduction. Cf. Illinois, 5 JONES STAT. ANN. § 32.006; Md. ANN. CODE, art. 23, § 54; OHIO CODE ANN. (Throckmorton, 1940) § 8623-41.

untrammelled discretion to buy shares out of any kind of surplus⁴⁰ (or in several important states only out of earned surplus),⁴¹ sometimes with a proviso that the purchase shall not be made if there is reasonable ground for believing that the corporation is unable or will thereby be made unable to satisfy its debts as they fall due.⁴² There are, however, a number of states in which the statute requires a shareholders' vote for the purchase of shares,⁴³ and a few in which such purchases are entirely forbidden.⁴⁴

40. Some of the following statutes restrict purchases to those made out of surplus or surplus profits; others to those which do not impair capital: ARK. DIG. STAT. (Pope, 1937) § 2155 (e); COL. STAT. ANN. (Michie, 1935) c. 41, § 24; DEL. REV. CODE (1935) c. 65, § 19; FLA. COMP. GEN. LAWS ANN. (Skillman, 1927) § 6534; IND. STAT. ANN. (Burns, 1933) § 25-202; Louisiana, L. 1928, Act 250, § 23 (vote of two-thirds of each class required, with certain exceptions); MD. ANN. CODE, art. 23, § 54 (vote of two-thirds of each class of shares required unless the charter authorizes purchases of shares); MICH. STAT. ANN. (Henderson, 1936) § 21.10; MO. REV. STAT. (1929) § 4940; NEV. COMP. LAWS (Hillyer, 1929) § 1608, as amended by L. 1931, c. 224, § 6; NEW YORK PENAL LAW, § 664; OHIO CODE ANN. (Throckmorton, 1940) § 8623-41 (shareholders' vote required unless the articles authorize the directors to purchase); OKLA. STAT. ANN. (1936) tit. 18, § 58 (from surplus profits or by unanimous written consent of shareholders); PA. STAT. ANN. (Purdon, 1930) tit. 15, § 2852-302 (7); R. I. GEN. LAWS ANN. (1938) c. 116, § 5 (g); TENN. CODE ANN. (1932) § 3722 (9); W. VA. CODE ANN. (1931) c. 31, art. I, § 39.

41. CAL. CIVIL CODE (Deering, 1937) § 342, and KAN. LAWS (1939) c. 152, § 24, permit purchase out of earned surplus only; Illinois in 5 JONES STAT. ANN. § 32.006, has a more complicated provision nearly equivalent to an earned surplus rule. N. D. COMP. LAWS (1913) § 4531, and OKLA. STAT. (1931) § 9747, limit purchases to those made out of "surplus profits" except where unanimous consent of shareholders is obtained. The term "surplus profits" in the Oklahoma statute has, however, been given a very broad interpretation. *Western & Southern Fire Ins. Co. v. Murphy*, 56 Okla. 702, 156 Pac. 885 (1916). GA. CODE ANN. § 22-1828 (d), in general permits purchases out of surplus but limits them to earned surplus "where there is outstanding another class of shares having a distribution preference over the shares purchased". MINN. STAT. (Mason, Supp. 1938) c. 58, § 7492-21 (VI), likewise in general permits purchases out of surplus, either earned or paid in, but provides that "if the corporation has outstanding shares entitled to preferential dividends or to a preference upon liquidation, then only such shares may be purchased or redeemed out of paid-in surplus."

In addition to the above provision limiting purchase of shares to purchases out of earned surplus, California has the further provision that, if a surplus is created by capital reduction, such reduction surplus may, if the corporation has only one class of shares, be used for the purchase of such shares if such purchase is authorized by the holders of two-thirds of the shares other than those which are to be purchased. If the corporation has outstanding preferred shares, reduction surplus may be used for the purchase or redemption of such shares only. CAL. CIVIL CODE (Deering, 1937) § 348b.

42. Provisions of this sort exist in a number of states. See, e. g., CAL. CIVIL CODE (Deering, 1937) § 342; OHIO GEN. CODE (Throckmorton, 1940) § 8623-41. Their primary purpose is to furnish some protection to creditors in those situations in which the statute authorizes the corporation to purchase out of capital; but they have the effect, also, of prohibiting purchase in cases where the corporation has a surplus, but its quick asset position is such that use of any substantial part of the surplus for the purchase of shares would make the prompt payment of its debts impossible.

43. 2 CONN. GEN. STAT. (1930) § 3423, requires the affirmative vote of shareholders owning three-fourths of its outstanding stock except where the shares are acquired to prevent loss on a debt. It does not forbid purchase out of capital. 1 S. D. CODE (1939) § 11.0303, permits purchase only out of surplus and in addition requires a resolution by the shareholders or their unanimous consent in writing.

See also the Louisiana, Maryland and Ohio statutes, cited in note 40, *supra*.

44. WYO. REV. STAT. (1931) § 28-122, forbids purchase altogether; KY. STAT. (Carroll, Baldwin's 1936 Rev.) § 544, permits it only where done to prevent loss on a debt previously contracted. In a few states, statutes which permit the acquisition of shares in payment of debts have never been construed and might possibly be construed as forbidding ordinary purchases. See, e. g., VERMONT P. L. (1933) § 5814.

Statutory prohibition of purchase of shares except as a method of obtaining payment of a debt is common in the case of banks. See, e. g., MASS. GEN. LAWS (1932)

The assumptions behind provisions permitting the management to make purchases out of surplus appear to be that creditors and shareholders have the right to insist that the capital fund be preserved, but that the use of surplus, or at any rate of earned surplus, for the purpose of buying shares is not a wrong to creditors and is a wrong to shareholders only if the transaction is entered into by the management for some improper motive. Where there is an improper motive, the shareholders are assumed to be adequately protected by their right to obtain redress for any violation by the managers of their fiduciary obligations.

These assumptions may well be challenged. Although purchases of shares out of surplus, or at least out of earned surplus, may, under some circumstances, be unobjectionable and even be advantageous to the corporate enterprise, such purchases are, in general, of dubious desirability. Investment for profit, on which our system of corporate capitalism is based, presupposes that corporate earnings, unless needed for investment in plant or as working capital, should normally be returned to all of the shareholders ratably in the form of dividends. The existence of a managerial power to purchase has, in practice, led to a wide variety of abuses such as purchase for stock-market manipulation; ⁴⁵ purchase in order to affect voting control; purchase in order to buy off a "troublemaker" whose troublemaking, however annoying to the management, may well be beneficial to the enterprise and to its shareholders; purchase from insiders at prices which are unfair to the corporation; and purchase from such insiders in order to enable them to withdraw from an enterprise which has a theoretical surplus but is actually in an unprosperous condition. Even though in most of these instances the purchase might, under existing statutes, be attacked as a violation of the management's fiduciary duties, the effect of such statutes is to make the purchase *prima facie* valid and to impose on an objecting shareholder the difficult burden of proving that the purchase involved a violation of the duty of loyalty.

Moreover, if the rule limiting purchase to surplus or to earned surplus is to mean anything substantial, it must mean that surplus

c. 172, § 39 (trust companies); PA. STAT. ANN. (Purdon, 1931) tit. 7, §§ 819-1009, 819-1011.

45. It is often contended that purchases by a corporation of its own shares for the purpose of market stabilization as distinct from speculation or manipulation should be regarded as legitimate. In seeking to defend purchases of shares of the Chicago Great Western Railroad Company by one of its subsidiaries—purchases which proved to be highly disadvantageous to the corporation—the chairman of the board has written, "We went into the transaction on the representation that many of our best friends among the shippers were being embarrassed by the low quotations on the stock, and that it was necessary to offer some help in return for what they had done for the Great Western." ADDITIONAL REPORT OF THE COMMITTEE ON INTERSTATE COMMERCE, UNITED STATES SENATE, Report No. 25, Part 14 (1940).

once used for the purchase of shares thereby ceases to be available either for further purchases of shares or for dividends, at least until the surplus is restored or, if one prefers, "unfrozen" by the resale of the shares.⁴⁶ If that be so, the use of surplus to buy corporate shares involves a serious inroad on what may well be regarded as the reasonable dividend expectations of the shareholder-owners of the business. It is, therefore, easier to prove that statutes like that of Connecticut,⁴⁷ which requires the consent of shareholders, or even statutes like that of Kentucky,⁴⁸ which limits purchases of shares to the cases in which the shares are taken to prevent loss on a previously contracted debt, are unfashionable, than to prove that they are unduly restrictive.

In any event, the power of the management to purchase out of surplus, if granted at all, should, in the case of shares of common stock, be limited to purchases out of earned surplus. Purchases of common shares out of surplus paid in by preferred shareholders is thoroughly vicious and might reasonably be held to be contrary to the fair implication of the preferred shareholders' contract even where the statute permits purchase out of surplus of any and all kinds. Purchase of common shares out of surplus paid in by subscribers to common shares should also be forbidden. If preferred shares are to be an appropriate investment medium, they must be safeguarded by a substantial cushion of assets made up of contributions by common shareholders which cannot be handed back to members of the latter group by a friendly management. Purchase of common shares out of paid-in surplus where the corporation has no outstanding preferred shares is less objectionable. Yet it is doubtful whether it is wise to empower the management to decide that a corporation which has no earnings should return part of the common shareholders' contributions to them either by way of dividends or of share purchases. Purchase of preferred shares out of paid-in surplus is a different matter, particularly where, as is generally the case today, the shares are made redeemable by the corporate charter. Because of the interrelation between redemption and purchase in the case of preferred shares, questions relating to purchase of such shares will be dealt with later, in that portion of this article which deals with redeemable shares.

46. Some modern statutes contain provisions clearly intended to make surplus used to purchase shares thereafter unavailable for dividends or additional purchases. See CAL. CIVIL CODE (Deering, 1937) §§ 342, 342a, 342b. The last section further provides that if the shares are resold the consideration received shall, except so far as needed to write off a capital deficit, be added to paid-in surplus, a fund which, under § 346, is unavailable for dividends except on preferred shares. See also Illinois, 5 JONES STAT. ANN., §§ 32.002 (j) (k) (m), 32.006.

47. See note 43, *supra*.

48. See note 44, *supra*.

It may be urged that, inasmuch as most of our corporation statutes permit corporations to reduce their capital by a shareholders' vote and to distribute the reduction surplus thereby created as a dividend, statutes prohibiting the use of capital for the purchase of shares are largely futile as a protection to creditors. It may well be that our statutory provisions with respect to capital reduction need overhauling, but even from the angle of creditor protection there is a wide difference between permitting the management to reduce the capital of a shaky enterprise by purchasing the shares of favored holders, and permitting the management to propose a plan for capital reduction which requires shareholder assent in order to be effective. That purchases of shares have frequently been an important contributing cause of ultimate insolvency is readily demonstrable; that capital reduction has, except in a few sporadic cases, been a contributing factor in causing enterprises to fail would be difficult to establish.

Sanctions for Enforcing Restrictive Statutes

Most of the statutes which limit corporate authority to purchase shares are phrased in terms of prohibition and do not contain any explicit statement as to the sanctions by which the restrictions which they purport to impose may be enforced. Some of the sanctions are obvious enough. A statute which provides that a corporation shall purchase shares only out of surplus (or, what would seem to amount to the same thing, that it shall not purchase them if its capital is impaired or would be impaired by the transaction) indubitably has the effect of making its promise to purchase unenforceable if it has not sufficient surplus with which to pay the price.⁴⁹ Moreover, since it is the use of capital for this purpose which is objectionable, the legally significant date is the date when performance of the contract is sought, rather than the date on which it is made.⁵⁰

49. *Pasotti v. United States Guardian Corp.*, 18 Del. Ch. 1, 156 Atl. 255 (1931), holding such an agreement unenforceable even against a corporation which was in liquidation and had paid all its debts. *Richards v. Weiner Co.*, 207 N. Y. 59, 100 N. E. 592 (1912), holding that the burden is on the corporation to show its present lack of surplus and consequent legal liability to perform. *But cf. Cross v. Beguelin*, 252 N. Y. 262, 169 N. E. 378 (1929), where, on a peculiar state of facts, the agreement was held to be enforceable in competition with the claims of certain subsequent creditors.

It would presumably be held that the performance of a contract to purchase could be enjoined by a shareholder who could show that the corporation had no surplus. *Cf. Stott v. Orloff*, 261 Mich. 302, 246 N. W. 128 (1933).

50. There seems to be no judicial dissent from this proposition, if we exclude the cases discussed below in which the real question is whether a contract of purchase is performed by the giving of a corporate note or only by the payment of the note. See *In re Tichenor-Grand Co.*, 203 Fed. 720 (S. D. N. Y. 1913); also cases cited in note 49, *supra*.

The same view is taken in cases arising under the common-law rule permitting purchases out of capital by solvent corporations, solvency at the date of the contract being insufficient if the corporation is insolvent at the date of performance. *Keith v. Kilmer*, 261 Fed. 733 (C. C. A. 1st, 1920), *cert. denied*, 252 U. S. 578 (1920), same case, 272 Fed. 643 (C. C. A. 1st, 1921), *cert. denied*, 257 U. S. 639 (1921) (involving

The answer to a closely related question is more doubtful. Suppose that, at a time when the corporation has a surplus and could legally buy some of its shares with cash, it enters into an arrangement with a shareholder whereby he surrenders his share certificate and purports to give up all of his rights as a shareholder in return for a promissory note of the corporation. If the corporation becomes insolvent or loses its surplus before the note falls due, has it a valid defense against liability on the note, if the latter is still in the hands of the former shareholder? In *In re Fecheimer Fishel Co.*⁵¹ the Circuit Court of Appeals for the Second Circuit answered this question in the affirmative, and there are several later decisions in accord with this view.⁵²

These decisions treat the subsequent payment of a note which was given in exchange for contemporaneously surrendered shares as an unlawful application of corporate funds to the purchase of shares. If a shareholder in a highly prosperous company should exchange his shares for a note or bond and thus lose his claim to substantial dividends which were subsequently declared, it would be decidedly harsh to deny him recovery on his note or bond merely because, after a lapse of several years, the corporation's financial condition had changed for the worse. One may, however, hazard the prediction that such a case will be of rare occurrence. Shareholders in genuinely successful corporations do not often exchange their status for that of creditors.⁵³

a Maine corporation; holding that the question of the claimant's right to recover if assets remained after all creditors had been paid was not properly before the court); *Boggs v. Fleming*, 66 F. (2d) 859 (C. C. A. 4th, 1933) (involving a Virginia corporation). *But cf.* *Scriggins v. Thomas Dalby Co.*, cited note 35, *supra*, holding insolvency occurring subsequent to the bringing of suit against the corporation to be immaterial.

51. 212 Fed. 357 (C. C. A. 2d, 1914), *cert. denied*, 234 U. S. 760 (1914). The case involved a corporation which was governed by NEW YORK PENAL LAW, § 664, cited note 37, *supra*.

52. *Robinson v. Wangemann*, 75 F. (2d) 756 (C. C. A. 5th, 1935); *In re O'Gara & Maguire*, 259 Fed. 935 (D. N. J. 1919). In both cases, proof of claim on a note given by a corporation for its shares was denied where the corporation had become insolvent subsequent to the giving of the note. Neither case involved any statute limiting the power to purchase. See also *In re Vulcan Soot Cleaner Co.*, 11 F. Supp. 388 (W. D. Pa. 1935), involving a Delaware corporation. The shares were returned to the seller as collateral security for the corporation's note, but this fact is not made the basis of the decision.

But cf. *Wolff v. Heidritter Lumber Co.*, 112 N. J. Eq. 34, 164 Atl. 140 (Ch. 1932).

53. It is probable, however, that in the case of some small corporations whose shares have no ready market, the exchange of shares for notes is due less to doubts about the solvency of the enterprise than to a desire on the part of a shareholder for a more liquid asset or to a desire on the part of the management to get rid of a troublemaker as a shareholder and to do so without the immediate drain on the corporation's current funds which would be brought about by a cash payment. *Cf.* *Boggs v. Fleming*, 66 F. (2d) 859 (C. C. A. 4th, 1933), cited note 50, *supra*, in which the primary purpose of the transaction seems to have been to eliminate the plaintiff, who was president as well as a substantial shareholder, from the enterprise as rapidly as possible. The agreement provided for immediate release of the corporation from his employment contract, exchange of his common shares for preferred shares, and the gradual reduction of the latter through the payment of \$25,000 in ten annual installments. See also *Loveland v. Doernbecher Mfg. Co.*, 149 Ore. 58, 39 P. (2d) 668 (1934), cited note 28, *supra*.

On the other hand, insiders who know that, although the corporation has a theoretical surplus, it is actually in an unprosperous condition, would be offered a tempting opportunity to "rat" while the ratting is good if the courts were to hold that, despite the subsequent insolvency of the corporation, corporate notes issued in exchange for shares are enforceable, in the absence of proof that a book surplus existing at the time of the exchange was legally nonexistent.

A quite different question is presented by cases in which the purchase is completed by the payment of cash at a time when the corporation, although solvent, has no surplus. If the shareholder knew of the lack of surplus, he has knowingly participated in an unlawful act and he should be under a duty to refund the purchase price, at suit of the corporation or of its receiver or trustee in bankruptcy.⁵⁴ But what of the innocent shareholder-participant in such a transaction? Should the latter's ignorance of the corporation's financial condition, or his honest and perhaps reasonable belief in the existence of an adequate surplus, be a defense to an action subsequently brought by the corporation, or by a representative of its creditors to compel him to refund the amount which he has received? Few statutes touch the point even by implication.⁵⁵

Decisions holding that an innocent recipient of unlawful dividends need not refund them if the corporation was solvent when the dividend was paid are clearly distinguishable. The shareholder is a mere passive recipient of dividends;⁵⁶ he is an active participant in a sale of his shares. Receipt of dividends is an ordinary transaction, occurring at frequent intervals. Purchase, even though generally valid if a surplus does exist, is an unusual transaction, a single instance unlikely to recur so far as the individual shareholder is concerned. The legal power of successful corporations to declare dividends is essential to the proper functioning of modern capitalism and one who re-

54. The purchase out of capital in violation of statute is a misuse of corporate funds and a wrong to the other shareholders and not merely to the creditors.

But cf. CAL. CIV. CODE (Deering, 1937) § 365, which limits liability to one "who sells such shares knowing that the corporation is the purchaser with knowledge of facts indicating the impropriety of such purchase", and imposes it only if the corporation is adjudged insolvent or bankrupt in any proceeding brought within a year.

55. Cf. MD. ANN. CODE (Flack, 1939) art. 23, § 54 (3) (7), which limits purchases to those out of surplus and provides that, if the purchase is in violation of the Act, the recipient of payment shall be liable to refund it so far as needed to pay corporate debts existing at the time of payment.

But cf. CAL. CIV. CODE (Deering, 1937) § 365, cited note 54, *supra*. See also OHIO CODE ANN. (Throckmorton, 1940) § 8623-123b, imposing liability to the corporation on those who knowingly accept or receive any unauthorized "dividend or distribution".

MICH. STAT. ANN. (Henderson, 1936) tit. 15, § 21.48, and MINN. STAT. (Mason, Supp. 1938) § 7492-22, impose liability to the corporation on all shareholders who receive any unauthorized dividends or distributions.

56. In *Wood v. National City Bank*, 24 F. (2d) 661, 662 (C. C. A. 2d, 1928), Judge Learned Hand said that the payment of dividends out of capital "is primarily only the wrong of those who commit it [the directors], like any other tort, and innocent participants [the recipient shareholders] are not accomplices in its commission."

ceives a dividend from a supposedly successful corporation assumes that he is merely reaping the normal reward which our economic system holds out and must hold out as an inducement to those who supply business with its essential funds. The seller of shares to a supposedly prosperous corporation, on the other hand, is taking part in a transaction which would, even if the supposed surplus existed, be one which the law may be regarded as tolerating rather than encouraging.

In fairness not only to creditors but also to other shareholders, who are likely to be adversely affected by purchases which impair capital, the selling shareholder should not be permitted to receive corporate assets in payment, except subject to a duty to disgorge if it later turns out that the sale was unlawful.⁵⁷ On the other hand, one who reasonably believes that the purchaser of his shares is someone other than the corporation should not be compelled to refund money, which unknown to him came from the corporation, even though the payment impaired its capital.⁵⁸

What of the liability of directors who authorize the purchase? Statutory provisions that explicitly relate to such liability are exceedingly uncommon,⁵⁹ but statutes that impose liability on directors for declaration of improper dividends are frequently so phrased as to include other unlawful distributions of capital.⁶⁰ Such statutes generally limit liability to negligent or willful misconduct,⁶¹ a limitation which is equitable in view of the fact that directors do not as such obtain any of the fruits of such distributions. The questions of what

57. *Cf. Uffelman v. Boillin*, 19 Tenn. App. 1, 40, 82 S. W. (2d) 545, 568 (1935), holding shareholders liable to refund where the law did not permit purchase unless proper steps had been taken for capital reduction, but approving the Chancellor's decree which limited recovery by a receiver of a solvent corporation to recovery for the benefit of those shareholders who had not approved of or acquiesced in the transaction.

58. Recovery has been denied under such circumstances in several cases involving illegal purchases of their own shares by banks or trust companies. *Johnston v. Laffin*, 103 U. S. 800 (1880); *Corn v. Skillen*, 75 Ark. 148, 87 S. W. 142 (1905). *Contra: Crandall, Receiver v. Lincoln*, 52 Conn. 73 (1884), cited note 21, *supra*.

59. For such a statute, see CAL. CIV. CODE (Deering, 1937) § 363.

60. For such statutes, see ILLINOIS, 5 JONES STAT. ANN. § 32.042; NEW YORK STOCK CORPORATION LAW, § 58, as amended by L. 1939, c. 364; OHIO CODE ANN. (Throckmorton, 1940) § 8623-123b; PA. STAT. ANN. (Purdon, 1938) tit. 15, § 2852-707.

For cases holding directors liable for improper purchases of shares, see *Jesson v. Noyes*, 245 Fed. 46 (C. C. A. 9th, 1917), permitting recovery by a receiver against directors of a Nevada corporation who caused it to buy its shares out of capital in violation of a statute of that state; *Re Burnett-Clark, Ltd.*, 56 F. (2d) 744 (C. C. A. 2d, 1932), permitting recovery by a trustee in bankruptcy of a Maryland corporation doing business in New York against its directors for purchasing shares out of capital, the liability being based on §§ 58 and 114 of the Stock Corporation Law, §§ 60 and 61 of the General Corporation Law, and §§ 664 and 667 of the Penal Code of New York; *New York Credit Men's Ass'n v. Harris*, 170 Misc. 988, 11 N. Y. S. (2d) 435 (1939), allowing recovery against directors of a New York corporation by an assignee for creditors suing on behalf of subsequent creditors. The suit was said to be maintainable under § 58 of the Stock Corporation Law and also under § 60 of the General Corporation Law.

61. But see PA. STAT. ANN. (Purdon, 1938) tit. 15, § 2852-707. *Cf. Uffelman v. Boillin*, 19 Tenn. 1, 38, 82 S. W. (2d) 545 (1935), in which directors who, acting on legal advice, erroneously believed that they had the right to cause their corporation to purchase its own shares, were held not liable for making such purchase.

the standard of care should be, and of who should bear the burden of proof⁶² will arouse more difference of opinion. This is particularly true in cases where directors who have failed to provide their corporation with an adequate accounting system seek to rebut a claim of negligent conduct by showing honest reliance on erroneously kept books or balance sheets.⁶³

Repurchase Agreements Made as Terms of Original Subscriptions

Many of the cases on purchase of shares involve purchases made pursuant to a stipulation in the original subscription obligating the corporation to repurchase the shares under certain circumstances. The most common type of such repurchase agreements is a promise made to a prospective subscriber that if the latter will subscribe and pay for shares, the corporation will subsequently repurchase them at the original price should the subscriber become dissatisfied with his bargain. Such a provision is calculated to deprive the corporation of capital at the time when it needs it most, and thus to jeopardize the claims of its creditors. "Your money back if you are not satisfied with our product" is a promise wholly unsuited to a transaction in which "our product" is a certificate representing ownership rights in a corporation and purporting to involve a permanent contribution to its capital.

If, however, the state does not effectively prevent corporations from baiting the hook for the investor in this manner, it is easy to lend a sympathetic ear to the investor's contention that the promise to repurchase, which induced him to part with his money, should be enforced, even in the teeth of a statute forbidding purchases of shares out of funds other than corporate surplus. Repurchase agreements are part of the stock in trade of those security salesmen who distribute shares in speculative enterprises to financially illiterate and, generally speaking, relatively impecunious buyers.⁶⁴ Such persons are likely to

62. For statutory provisions as to the extent to which reliance on corporate books or balance sheets or statements prepared by appropriate officers or accountants are a defense to liability for improper distributions, see CAL. CIV. CODE (Deering, 1937) § 363; ILLINOIS, 5 JONES STAT. ANN. § 32.042; OHIO CODE ANN. (Throckmorton, 1940) § 8623-123b.

63. The New York statute, STOCK CORPORATION LAW, § 58, as amended by L. 1939, c. 364, places the burden on the directors "affirmatively [to] show that they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital of the corporation, . . ."

64. The cases indicate that such repurchase agreements were widely used as inducements in the "customer-ownership" stock-selling campaigns which were engaged in by a number of public utility companies and public utility holding companies during the boom period of the nineteen-twenties. Some of this stock was of a highly speculative character.

Two cases, *Thomas v. People's Gas & Elec. Co.*, 220 Iowa 850, 263 N. W. 499 (1935), and *Beckroge v. South Carolina Public Service Co.*, 185 S. C. 210, 193 S. E. 315 (1937), involve agreements by a public utility company to repurchase shares of its parent corporation. Although the purchase by a corporation of shares of its corporate parent is in some respects even more objectionable than purchase of a corporation's

be financially less able to suffer the hardship of losing their money than is the average corporate creditor. It is, therefore, not surprising that in most of the earlier cases the courts permitted the shareholder to get his money back without inquiry as to the existence of any corporate surplus,⁶⁵ nor is it surprising that a number of courts reached this result in spite of statutes which had previously been construed as forbidding purchases of shares, or purchases which involved a withdrawal of capital.⁶⁶ Various legal formulae have been made use of in an effort to rationalize this result.⁶⁷ All of them, however, slur over the patent fact that, if such agreements are enforceable despite the non-existence of surplus, shareholder-owners are thus, by virtue of an invisible and unsuspected string attached to their shares, allowed to impair the margin of safety provided for creditors.

Even those courts which adopt a sympathetic attitude towards investors who have purchased in reliance on such agreements generally refuse to enforce them if the corporation is insolvent at the time when the shareholder seeks to obtain repayment.⁶⁸ Nearly all of the recent

own shares, very few statutes place any restrictions on the former type of purchase. But see CAL. CIV. CODE (Deering, 1937) § 342. See also ADDITIONAL REPORT OF THE COMMITTEE ON INTERSTATE COMMERCE, UNITED STATES SENATE, note 45, *supra*, which deals with a purchase of Chicago Great Western shares by one of its subsidiaries.

In the *Beckroge* case, a charter provision empowering the corporation to purchase shares in other companies was held to authorize the making of an agreement by a subsidiary, which was selling its parent's shares as agent of the latter, that it would repurchase the shares.

65. See, e. g., *Vent v. Duluth Coffee & Spice Co.*, 64 Minn. 307, 67 N. W. 70 (1896); *United States Mineral Co. v. Camden & Driscoll*, 106 Va. 663, 56 S. E. 561 (1907); *Adam v. New England Investment Co.*, 33 R. I. 193, 80 Atl. 426 (1911); *Wolf v. Excelsior A. S. & S. Co., Inc.*, 270 Pa. 547, 113 Atl. 569 (1921).

For recent statutory changes in Pennsylvania, Rhode Island and Minnesota, see notes 40 and 41, *supra*.

66. *Ophir Consol. Mines Co. v. Brynteson*, 143 Fed. 829 (C. C. A. 7th, 1906) (Colorado statute prohibiting purchase); *Mulford v. Torrey Exploration Co.*, 45 Colo. 81, 100 Pac. 596 (1909) (same Colorado statute); *Schulte v. Boulevard Gardens Land Co.*, 164 Cal. 464, 129 Pac. 582 (1913) (statute prohibiting division of any part of the capital stock or reduction of stock except as provided by law); *Sweeny v. United Underwriters Co.*, 29 S. D. 576, 137 N. W. 379 (1912) (substantially similar statute).

For the present statutory law of California, see notes 39 and 41, *supra*; for that of Colorado, see note 40, *supra*.

For early decisions unfavorable to such agreements, see *Wilson v. Lorchon Lace & Mercantile Co.*, 167 Mo. App. 305, 149 S. W. 1156 (1912); *In re Tichenor-Grand Co.*, 203 Fed. 720 (S. D. N. Y. 1913), cited note 50, *supra*.

67. Such as (a) that the contract is one of "sale or return" (although it is hard to see how this concept is of assistance in determining whether the "or return" provision is valid), *Ophir Consol. Mines Co. v. Brynteson*, 143 Fed. 829 (C. C. A. 7th, 1906), cited note 66, *supra*; (b) that the contract, even if ultra vires, is enforceable against the corporation because the latter, having received benefits under it, is estopped to set up its invalidity, *Colorado Industrial L. & I. Co. v. Clem*, 82 Colo. 399, 260 Pac. 1019 (1927); and (c) that if the repurchase agreement is invalid, the shareholder is entitled to recover on a theory of rescission, *Vent v. Duluth Coffee & Spice Co.*, 64 Minn. 307, 67 N. W. 70 (1896), cited note 65, *supra*; *Sweeny v. United Underwriters Co.*, 29 S. D. 576, 137 N. W. 379 (1912), cited note 66, *supra*; *Griffin v. Bankers Realty Investment Co.*, 105 Neb. 419, 181 N. W. 169 (1920).

68. *White v. Lorimer's City Dye Works*, 46 Idaho 490, 269 Pac. 90 (1928); *McIntyre v. E. Bement's Sons*, 146 Mich. 74, 109 N. W. 45 (1906); *Davies v. Montana Auto Finance Corp.*, 86 Mont. 500, 284 Pac. 267 (1930); *Grinde v. Dakota Trust & Savings Bank*, 54 S. D. 175, 222 N. W. 670 (1929) (involving shares of a subsidiary

cases arising under statutes which explicitly limit purchases to surplus⁶⁹ or forbid purchases out of capital⁷⁰ have gone further and held that these repurchase agreements constitute no exception to the statutory rule. Whether this modern trend is due to increasing judicial awareness of the evil effects, on shareholders and creditors alike, of permitting capital to be dissipated in this manner, or is due to the greater explicitness of most of the more recent statutory provisions imposing restrictions on purchases of shares, is not entirely clear. At all events, in jurisdictions where there are no statutory provisions on the subject, the judicial tendency is still in the direction of permitting one who has purchased shares on the faith of a repurchase agreement to recover his money, provided the corporation remains solvent. This is so even where the facts indicate or strongly suggest that the corporation had no surplus.⁷¹ However, in many of the cases there is no suggestion in the opinion that the defendant corporation, which was resisting enforcement of a repurchase agreement on other grounds,⁷²

corporation). In the Idaho and Michigan cases the court said that it was unnecessary to decide whether the contract was valid apart from the insolvency.

69. *In re Tichenor-Grand Co.*, 203 Fed. 720 (S. D. N. Y. 1913), cited note 50, *supra*; *Richards v. Weiner*, 207 N. Y. 59, 100 N. E. 592 (1912), cited note 49, *supra* (stating that a repurchase agreement should be construed as an agreement to buy only out of surplus, as otherwise it would be invalid); *Topken, Loring & Schwartz, Inc. v. Schwartz*, 249 N. Y. 206, 163 N. E. 735 (1928) (declining to enforce a repurchase agreement against the shareholder on the ground that the corporation's promise to repurchase, being enforceable only if it had a surplus, was illusory). All these cases involve repurchase agreements made with employee-subscribers.

70. *Pasotti v. United States Guardian Corp.*, 18 Del. Ch. 1, 156 Atl. 255 (1931), cited note 49, *supra* (refusing to enforce a repurchase agreement against a corporation which was in receivership but had paid all its debts); *Bishop v. Middle States Utilities Co.*, 225 Iowa 941, 282 N. W. 305 (1939) (holding the answer of a Delaware corporation that it had no surplus with which to carry out its repurchase agreement good on demurrer); *Cleveland v. Jencks Mfg. Co.*, 54 R. I. 218, 171 Atl. 917 (1934) (involving an agreement between a corporation which later became insolvent and its employee that the corporation would procure a guaranty from a third party to purchase the employee's share at a certain price). *But cf. Colorado Industrial L. & I. Co. v. Clem*, 82 Colo. 399, 260 Pac. 1019 (1927), cited note 67, *supra*, in which the court said that, even though the corporation had no surplus, the purchase would not impair the capital if the purchased shares were retained in the treasury available for resale.

For cases holding that other types of restrictive statutory provisions invalidated a repurchase agreement, see *Pothier v. Reid Air Spring Co.*, 103 Conn. 380, 130 Atl. 383 (1925); *Merchants' Wholesale Grocery Co. v. Bond-Foley Lumber Co.*, 222 Ky. 320, 300 S. W. 872 (1927); *Norwalk v. Marcus*, 235 App. Div. 211, 256 N. Y. Supp. 697 (1st Dep't 1932), *aff'd mem.*, 261 N. Y. 615, 185 N. E. 761 (1933). In *Hansen v. California Bank*, 17 Cal. App. (2d) 80, 61 P. (2d) 794 (1936), the statute, which has since been repealed, specifically forbade repurchase agreements, except in the case of subscriptions by employees.

71. *Oklahoma Natural Gas Corp. v. Douglas*, 170 Okla. 284, 39 P. (2d) 578 (1934); *Mississippi Power Co. v. Bennett*, 173 Miss. 109, 161 So. 301 (1935); *Grace Securities Corp. v. Roberts*, 158 Va. 792, 164 S. E. 700 (1932); *Learmouth v. Caledonia County Co-op. Creamery Ass'n, Inc.*, 109 Vt. 526, 1 A. (2d) 732 (1938). In the Oklahoma case, the plaintiff's recovery was based on the theory that the repurchase agreement was made fraudulently, without intent to perform it. *But cf. Harriman Nat. Bank v. Perry*, 86 F. (2d) 641 (C. C. A. 2d, 1936).

For additional cases on the general subject of repurchase agreements made contemporaneously with the original subscription, see Note (1936) 101 A. L. R. 154.

72. Such as lack of authority in the selling agent to make the repurchase agreement, the statute of frauds, and the parol evidence rule. Attempts to resist recovery on these grounds have rarely been successful.

had made the point that its capital was impaired. A company which was still a going concern might well be reluctant to advertise its financial difficulties by making such a defense, particularly in a jurisdiction in which the legal validity of the defense was doubtful. Two courts have, however, recently recognized the unfairness to other shareholders of repurchase agreements by refusing to enforce them on the ground that they violate the principle of equality of treatment as between shareholders of the same class.⁷³

In addition to being used as a stock selling device, repurchase agreements are also frequently entered into as part of an arrangement by which an employee of a corporation subscribes to some of its shares with an agreement that, on termination of his employment, he will resell his shares to the company. The agreement may obligate the corporation to buy, as well as the employee to sell. In some cases it is in the form of an option to the employee to sell on terminating his employment, without his being obligated to do so.⁷⁴

Some labor union leaders and labor sympathizers regard proposals for the purchase of shares of a corporate employer by non-management employees with suspicion as Munich-like appeasement offers aimed at breaking down labor's will to fight for higher pay and shorter hours and at reducing its will to prepare for such fighting by organizing itself. One cannot, however, reasonably expect that the business organizations law of a capitalistic society will be based on the premise that anything which tends to dull the fighting edge of labor in a class war with capital is contrary to public policy. In the present state of society, judges and legislators are likely not only to tolerate, but affirmatively to approve plans for giving labor a financial interest in industry through share ownership.⁷⁵ Moreover, most of the litigated cases have involved sales of shares to executives rather than to the type of employee who would be regarded as a good prospect for labor union membership.

Repurchase agreements are a common, perhaps almost a necessary concomitant of employee-purchase plans, particularly in the case of the smaller corporations. The primary purpose of such plans is to

73. *Hoopes v. Leddy*, 119 N. J. Eq. 206, 182 Atl. 271 (Ch. 1936); *West Texas Utilities Co. v. Ellis*, 126 S. W. (2d) 13 (Tex. Comm. App. 1939). In the latter case, the statute was construed to require such equality. Both cases relate to preferred shares.

74. Various legal questions which arise in connection with such plans are discussed in Fordham, *Some Legal Aspects of Employee Stock Purchase Plans* (1930) 8 N. C. L. Rev. 161.

75. This share ownership was estimated in 1928 to amount to over \$1,000,000,000 in value, or about one per cent. of the then value of all American corporate stock. NATIONAL INDUSTRIAL CONFERENCE BOARD, INC., *EMPLOYEE STOCK PURCHASE PLANS IN THE UNITED STATES* (1928).

give the employees a stake in the enterprise in which they are employed.⁷⁶ Generally speaking, neither party desires that the stake continue if the employment relationship ceases to exist. One who has formerly worked for, but is now no longer connected with a corporation and who originally invested in its shares because of his employment may well feel that the continuation of this investment under the changed conditions is undesirable, particularly if the shares have no ready market.⁷⁷ The corporation, on its side, is likely for several reasons to desire the power to repurchase the shares on termination of the employment. It may be reluctant to have them remain in the hands of one who may now be in the employ of a competitor. It may wish to acquire them so that it can sell shares to the employee's successor without the necessity of increasing its capital. If the shares have been offered to the employee at less than their value, it will seek to prevent his profiting from this low offer by quitting his job as soon as he has acquired the shares.

In view of the special circumstances under which the investment is made; the application of a rule of law limiting repurchase to cases in which the corporation has a sufficient surplus for that purpose will have unfortunate consequences for both parties, particularly for the employee-investor. The corporation's failure to earn a surplus may result in curtailment of its working force and in loss of the employee's job. If, in addition, his savings are frozen in non-dividend-paying and unmarketable shares which the corporation cannot legally buy from him despite its promise to do so, his plight is a serious one. The harshness of this result is accentuated if, as is sometimes the case, his original investment was made under a considerable amount of compulsion.

If we really want to promote, and not merely to tolerate, a type of share subscription which is advocated by its proponents largely for the very reason that it serves other purposes than that of contributing to corporate capital, it may well be that we should relieve this special type of shareholder from the full rigor of the rule which refuses to permit shareholders to withdraw any part of the corporate capital. Nevertheless, if such an exception is to be made, it should, at least in jurisdictions where the statute specifically forbids purchases that impair capital, be made by a special statutory provision rather than by a

⁷⁶ Sale of securities to employees may be motivated to some extent also by the desire to tap an additional source of new capital and to do so without incurring any stock-selling expense.

⁷⁷ Moreover, most such plans provide for payment for the shares by installments. An employee who loses his job, perhaps without obtaining another, is not likely to be in a position to continue to make installment payments, and naturally desires to have the payments already made refunded.

judge-made exception to the general rule. Such special statutory provisions exist in a few states.⁷⁸

Judicial decisions on the subject have not in fact distinguished this type of repurchase agreement from those made with non-employee investors. In cases which involve repurchase agreements with employees, as in other cases, the agreement has, in the absence of restrictive statutes, generally been treated as enforceable without regard to the existence of surplus.⁷⁹ Statutes stipulating that the directors shall not permit the withdrawal of capital have been variously construed,⁸⁰ and the corporation laws of New York and Delaware, which specifically limit purchases, in the first state to those made out of surplus,⁸¹ and in the second to those which do not impair capital,⁸² have been held applicable to repurchase agreements with employees.

Federal Statutes and Regulations

Recent federal statutes and the regulations of the Securities and Exchange Commission adopted pursuant thereto affect the purchase of shares in two ways: (a) by regulating stock market operations by all types of companies, and (b) by regulating all forms of purchase of their own shares by particular classes of companies.

Stock market operations by a corporation with a view to pegging the market are now regulated by Section 9 (a) (6) of the Securities Exchange Act of 1934, which makes it unlawful for any person

“To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

78. See CAL. CODE CIV. PROC. (Deering, 1937) § 342; OHIO CODE ANN. (Throckmorton, 1940) § 8723-41.

79. *Strodl v. Farish-Stafford Co.*, 145 App. Div. 406, 130 N. Y. Supp. 35 (1st Dep't 1911), involving North Carolina and Connecticut corporations; *Koch v. Val Verde Mercantile Corp.*, 4 S. W. (2d) 662 (Tex. Civ. App. 1928).

80. In *Williams v. Maryland Glass Corp.*, 134 Md. 320, 106 Atl. 755 (1919), such a repurchase agreement was held enforceable by the corporation despite the existence of such a statute. A contrary view was taken in *Kom v. Cody Detective Agency*, 176 Wash. 540, 136 Pac. 1155 (1913), in which the contract was held unenforceable against a solvent corporation. The present Maryland statute limits purchases to surplus with certain exceptions not here material. MD. CODE ANN. (Bagby, 1937) art. 23, § 54.

81. For the effect of the New York statute on repurchase agreements with employees, see *Richards v. Weiner*, 207 N. Y. 59, 100 N. E. 592 (1912); *In re Tichenor-Grand Co.*, 203 Fed. 720 (S. D. N. Y. 1913); *Topken, Loring & Schwartz, Inc. v. Schwartz*, 249 N. Y. 206, 163 N. E. 735 (1928).

82. *Hegarty v. American Com. Power Corp.*, 20 Del. Ch. 231, 174 Atl. 273 (1934). The corporation was insolvent, but the court stated broadly that the statutory prohibition of purchases which impair capital is applicable to repurchase agreements with employees. *Cf. Cleveland v. Jencks Mfg. Co.*, 54 R. I. 218, 171 Atl. 917 (1934).

In addition, a ruling of the Federal Trade Commission; the predecessor of the Securities and Exchange Commission as enforcement agency for the Securities Act of 1933,⁸³ that a corporation which desires to resell to the public shares which it has acquired must register them under that act, has had a strong tendency to discourage repurchases made with a view to what Lord Herschell called "trafficking in the shares".⁸⁴

National banks have long been forbidden to loan money on the security of their own shares or to purchase their own shares except where the transaction is necessary to prevent loss on a debt previously contracted in good faith.⁸⁵

Since 1935 it has been unlawful for any corporation which is subject to the Public Utility Holding Company Act of that year

"to declare or pay any dividend on any security of such company or to acquire, retire, or redeem any security of such company, in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate to protect the financial integrity of companies in holding-company systems, to safeguard the working capital of public-utility companies, to prevent the payment of dividends out of capital or unearned surplus, or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder."⁸⁶

Pursuant to this provision, the Commission has promulgated Rule U-12C-1 which, with certain exceptions, forbids registered holding companies and their subsidiaries to acquire, retire, or redeem any securities issued by them except in accordance with the declaration which has become effective as specified in Rule U-8. The latter rule provides that the Commission may require a public hearing if it deems such hearing to be appropriate, in the public interest, or in the interests of investors or consumers.

Investment companies have long been peculiarly prone to indulge in the practice of purchasing their own shares. Many of them are organized on the "open-end" plan, which makes their shares in effect redeemable at the option of the holder, and thus places them in the category of redeemable shares which are dealt with in the second section of this article. An investment company which is not so organized is commonly referred to as a "closed-end" company and is so designated in the Investment Company Act of 1940. The act forbids any such company to

83. F. T. C. Release No. 131, March 13, 1934.

84. See *Trevor v. Whitworth*, 12 App. Cas. 409, 417 (H. L. 1887).

85. REV. STAT. § 5201 (1927), 12 U. S. C. A. § 83 (1936), originally Act of June 3, 1864, c. 106, § 35, 13 STAT. 110.

86. 49 STAT. 823, 15 U. S. C. A. § 791 (c) (Supp. 1940).

“purchase any securities of any class of which it is the issuer except

(1) on a securities exchange or such other open market as the Commission may designate by rules and regulations or orders: Provided, that if such securities are stock, such registered company shall, within the preceding six months, have informed stockholders of its intention to purchase stock of such class by letter or report addressed to stockholders of such class; or

(2) pursuant to tenders, after reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased; or

(3) under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors in order to insure that such purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the class or classes of securities to be purchased.”⁸⁷

These provisions are obviously designed to prevent discrimination between shareholders in the purchase of shares. The Act does not place any limitations on the funds which may be used for the purchase of shares except where the investment company is issuing additional senior securities. If the new issue is to be an issue of debentures, the corporation must provide that no shares shall be purchased unless the value of the corporate assets, after deducting the purchase price of the shares, is equal to 300 per cent of the amount of the debentures. If the new issue is to be an issue of preferred shares, the corporation must provide that no shares of common stock shall be purchased unless the value of the corporate assets, after deducting the purchase price of the shares, is equal to 200 per cent of the amount of the preferred shares.⁸⁸

II. REDEMPTION OF SHARES

The term “redeemable shares” as used in this article will be confined to shares which are made redeemable by provisions in the articles of incorporation.⁸⁹ Redemption of such shares may be compulsory either at a fixed date or upon the happening of some contingency, or the redemption may be at the option either of the corporation or of

87. 76th Cong., 3d Sess., c. 686 (Aug. 22, 1940) § 23, 15 U. S. C. A. § 80a-23(c) (Supp. 1940).

88. 76th Cong., 3d Sess., c. 686 (Aug. 22, 1940) § 18, 15 U. S. C. A. § 80a-18 (Supp. 1940).

89. The effect of redemption provisions contained in by-laws or in share certificates will not be dealt with. Many modern statutes, if literally construed, require that such provisions be inserted in the articles of incorporation. Cf. *Gaskell v. Gladys Belle Co.*, 16 Del. Ch. 289, 146 Atl. 337 (1929).

the holder. Redemption provisions are, in general, unusual in the case of common shares. On the other hand, provisions for redemption, generally at the option of the corporation, have become almost universal in the case of preferred shares.⁹⁰ There are, however, two types of redeemable common shares which occur with sufficient frequency to deserve particular mention.

Redeemable Common Shares of "Open-end" Investment Companies

The articles of incorporation of many modern investment companies contain provisions to the effect that the company will repurchase such shares at any time, usually at a price slightly below their asset value.⁹¹ These companies, which are commonly known as "open-end" companies, have generally issued only one class of shares.⁹² The typical purchaser of shares in such companies is a person who desires to take advantage of the skill of their managers as investment experts and the dilution of risk which the diversified portfolio of such companies affords him, and who wishes at the same time to obtain a degree of liquidity equal to that which he would secure if he invested directly in the underlying securities. Unless the investment company is so large that its own shares have a broad market, its shareholders can obtain the liquidity which they desire only if the company itself agrees to purchase their shares at any time. For this and other reasons, there is a strong investor demand for the "open-end" plan of organization of such companies. If, as is generally the case, the discount from asset value which "open-end" companies agree to pay on redemption is insubstantial, the redemption price is fair both to the shareholders who withdraw and to those who remain in the enterprise. Although, as the Securities and Exchange Commission has pointed out,⁹³ there is the theoretical possibility that an investment company organized according to this plan may suffer the equivalent of a run on a bank, there would seem in practice to be little danger of serious consequences to the enterprise if its assets are invested in readily marketable securities; and the existence of such a redemption provision will have

90. For general discussions of legal problems relating to redeemable shares, see Jones, *Redeemable Corporate Securities* (1931) 5 So. CALIF. L. REV. 83; Note (1935) 83 U. OF PA. L. REV. 888. For a collection of cases, see Note (1934) 88 A. L. R. 1131.

91. See REP. S. E. C., INVESTMENT TRUSTS AND INVESTMENT COMPANIES, Pt. I, 27. The company's obligation is in some instances expressly limited to an obligation to purchase out of surplus.

92. See REP. S. E. C., *supra* note 91, Pt. II, 241. They are now required so to limit their issues by the Investment Company Act of 1940, § 18 (f) 1, 15 U. S. C. A. § 80a-18 (f) 1 (Supp. 1940). During the period from 1927 to 1936, the forty principal "open-end" investment companies paid \$142,000,000 in redeeming their securities, which was about one-fourth of the amount which they received from the sale of their shares during the same period. *Id.* at 242.

93. See REP. S. E. C., *supra* note 91, Pt. III, c. III, § 9 *et seq.*

a strong tendency to induce the management to invest in securities of that type.

It is true that, if the managers of such a company, which is faced with a substantial number of demands for redemption, are unwilling to liquidate part of the assets, they may borrow money for the purpose of complying with redemption demands. However, their power to do so has now been substantially restricted by the Investment Company Act of 1940.⁹⁴ Since their power to borrow is thus circumscribed and their assets are of a liquid character, it is reasonably safe to permit their managers to exercise a broad discretion in redeeming their shares, even by the use of capital or unearned surplus.

Nevertheless, there may be considerable doubt in a number of jurisdictions as to the legal power of investment companies to redeem their shares out of capital or out of unearned surplus, and even as to their power to issue such shares at all. Statutory provisions limiting ordinary purchases of shares to purchases out of surplus or even to purchases out of earned surplus are, as we have seen, very common today. Modern statutes do, indeed, frequently provide specifically for redeemable shares, and many of these statutes expressly state that such shares may be redeemed even where no surplus exists. Such express statutory authorizations of the issue of redeemable shares are, however, generally so phrased as to be applicable only to redeemable preferred shares and not to redeemable common shares.⁹⁵

There is a Delaware decision which construes a provision of this sort as impliedly negating the power to issue redeemable common shares at all.⁹⁶ There seem to be no decisions in other states construing similar statutes which authorize the creation of redeemable preferred shares and are silent with respect to the power to issue redeem-

94. Section 18 (f) 1, 15 U. S. C. A. § 80a-18 (f) 1 (Supp. 1940).

95. For statutes of this type see DEL. REV. CODE (1935) c. 65, §§ 13, 27; ME. REV. STAT. (1930) c. 25, § 20; N. J. REV. STAT. (1937) § 14-8-3; OKLA., 18 STAT. ANN. § 15; ORE. CODE ANN. (1930), § 25-224; VA. CODE (1936) § 3792; W. VA. CODE (1937) § 3034; WIS. STAT. (1937) § 182.13.

96. *Starring v. American Hair & Felt Co.*, 191 Atl. 887 (Del. Ch. 1937), *aff'd mem.*, 2 A. (2d) 249 (Del. Sup. Ct. 1937).

Section 13 of the Delaware Act authorizes corporations to classify shares and provides that "any preferred or special stock may be made subject to redemption". Section 27 of the same Act provides that "whenever any corporation . . . shall have issued any preferred or special shares, it may . . . redeem all or any part of such shares, if subject to redemption". The court in the *Starring* case treated § 27 as impliedly forbidding the issue of common shares which are "subject to redemption" at the option of the corporation. It is unlikely that the court would take a different view with respect to the power of a Delaware corporation to issue common shares which are redeemable at the option of the holder. If the phrase "subject to redemption" includes shares which are redeemable at the holder's option, the decision is logically applicable to such shares. If such shares are not regarded as "subject to redemption" within the meaning of the statute, then there is no statutory provision explicitly authorizing the issue of shares which are redeemable at the holder's option, even if such shares are preferred shares.

able common shares. The objections to allowing corporations of most types to issue redeemable common shares, and particularly common shares which are redeemable at the option of the holder, are, however, so serious and so self-evident that a construction of the statute which would prevent the issue of redeemable common shares is likely to be regarded by a court as dictated by sound policy as well as by the formalistic *expressio unius* rule of construction.

A statutory limitation of redeemable shares to redeemable preferred shares may be circumvented by forming a corporation with a large issue of preferred shares and a merely nominal amount of common shares, so that the corporation's preferred shares will be its ordinary shares. Although Section 18 (f) of the Investment Company Act of 1940 in general forbids "open-end" investment companies to issue preferred shares, the section contains a proviso which makes it possible for such a company to be organized in a state which does not permit the issue of redeemable common shares. The proviso permits an "open-end" company to issue preferred shares if its common shares are entitled to no dividends except dividends in liquidation, and if they do not amount to more than one-half of one per cent. of the issuer's outstanding voting securities.

Although most statutes which expressly authorize the issue of redeemable shares refer to preferred shares only, the Maryland statute provides that any class of shares may be made redeemable either at the option of the corporation or at the option of the holder.⁹⁷ It also contains special provisions with respect to the redemption and purchase of the shares of investment companies.⁹⁸ A number of "open-end" investment companies have been organized under this Maryland statute and others have avoided all such corporate problems by organizing as business trusts.⁹⁹

The Investment Company Act of 1940 makes no attempt to prescribe the funds which may be used by "open-end" investment companies in the redemption of their shares. Since such companies are forbidden by the Act to issue senior securities and are restricted in their power to borrow money on bank loans,¹⁰⁰ it is assumed that no limitation on the use of corporate capital for the purchase of shares is necessary. The limitations on redemption or purchase of shares by "open-end" companies which the Act does impose are of a quite different sort.¹⁰¹

97. MD. ANN. CODE, art. 23, § 42.

98. MD. ANN. CODE, art. 23, § 54 (8).

99. See REP. S. E. C., *supra* note 91, Pt. III, c. III, 5.

100. Section 18 (f), 15 U. S. C. A. § 80a-18 (f) (Supp. 1940).

101. Sections 11 and 22, 15 U. S. C. A. § 80a-11 and 22 (Supp. 1940).

*Corporate Options to Purchase Holdings of Shareholders Who
Desire to Sell*

The articles and the share certificates¹⁰² of small corporations (which usually issue only common shares) sometimes restrict the transferability of the shares by providing that a shareholder who desires to sell must give the corporation the option of purchasing. Although shares so restricted would probably not ordinarily be referred to by lawyers as redeemable shares, they are in fact contingently subject to redemption at the corporation's option, since the holder cannot sell to anyone without giving the corporation an opportunity to purchase.

It is extremely improbable that a court would construe statutes which appear to limit the power to issue redeemable shares to that of issuing redeemable preferred shares as invalidating options of this sort. The exercise by the corporation of its option to buy is more likely to be regarded as a "purchase" than as a "redemption" within the statutory meaning of that term.¹⁰³ If it is classed as a purchase for that purpose, is it also a purchase which falls within the common statutory prohibition of the use of capital for share purchases? There is something to be said, as a matter of policy, for exempting the transaction from such restrictions. The objective of preventing the introduction of strangers into these small corporations, an objective with which the law may properly be sympathetic, is not completely attainable if only purchases out of surplus are legally permissible, since the restriction on sales to others would probably be deemed an invalid restraint on alienation if it were so phrased as to prevent a sale to others where the corporation was legally unable to buy. On the other hand, these small closed corporations are likely to be companies which are engaged in active business operations that require a substantial margin of assets over debts for the protection of both shareholders and creditors. The dangers which are inherent in a power to reduce that margin through the use of capital in the purchase of shares are not eliminated by the fact that the existence of a conditional corporate option to purchase is disclosed by the articles of incorporation or in the share certificates.

There has been a considerable amount of litigation with respect to restrictions on the transfer of shares, but the cases have, in general, dealt with the possible invalidity of such restrictions as undue restraints on alienation rather than with the question of whether the

102. The Uniform Stock Transfer Act provides that there shall be no restrictions on transfer unless the restriction is stated upon the share certificate. 6 U. L. A. § 15.

103. In *Lawson v. Household Finance Corp.*, 18 Del. Ch. 343, 152 Atl. 723 (1930), the court, in upholding such a restriction on transfer, referred to the power given to Delaware corporations by § 19 of the General Corporation Law to purchase their own shares, and did not mention statutory restrictions on the issue of redeemable shares.

restriction, if otherwise valid, would give the corporation the legal power to purchase the shares out of capital. Ohio has, however, specifically provided for the purchase of shares irrespective of the existence of surplus in cases of this sort.¹⁰⁴

Callable Preferred Shares

Modern preferred share contracts generally contain provisions making the shares callable or redeemable at the option of the corporation, generally at a premium over par or over the original issue price if the shares are no-par shares. Such provisions are likely to prove beneficial to the common shareholders and to the enterprise as an economic unit. They make it possible to refund an issue of preferred shares if changes in the prosperity of the enterprise or in interest rates have made the dividend rate unnecessarily high, or if some provision in the preferred shareholders' contract has proved inconvenient. The well-informed modern investor in preferred shares expects that such shares will be made callable, and the less sophisticated investor is adequately protected if call provisions are given sufficient publicity at the time when the shares are being distributed.

There are strong arguments for permitting such shares to be redeemed out of capital. A statement in a corporation's articles that its preferred shares are callable at its option is public notice that the portion of its capital represented by such shares may, if the management so decides, be treated as a loan to be paid off or refunded rather than as a permanent contribution to the business. Although, generally speaking, it is unrealistic to treat the notice given by the filing of corporate articles as though it were actual notice, in this case the business community, creditors and investors alike, are familiar with call provisions and regard them as normal rather than as exceptional. A rule limiting redemption to redemption out of surplus would, if strictly construed, prevent a prosperous corporation from retiring an issue of preferred shares even with a view to refunding them at a lower dividend rate, unless it had accumulated a surplus equal to the entire amount of the issue. It would thus make it impossible to perform a desirable refunding operation, or force the corporation to carry out the operation in dribbles.

Despite the importance, as a general rule, of safeguarding corporate capital, the requirement of such meticulous stewardship of the "trust-fund for creditors" is scarcely necessary. The management of our corporations is ordinarily entrusted to persons who are identified in interest primarily with the common rather than with the preferred

104. OHIO CODE ANN. (Throckmorton, 1940) § 8623-41.

shareholders. The corporation's option to redeem its preferred shares is, therefore, unlikely to be exercised unless redemption will benefit common shareholders, and it will scarcely do so unless the corporation will, after paying the redemption price, have a substantial margin of assets over liabilities. There is thus no very serious risk that redemption, even out of capital, will dangerously impair the creditors' margin of safety. The fact that redemption must ordinarily be made at a premium is a further safeguard against the possibility that an unprosperous corporation will exercise its option to redeem.

The *purchase* of redeemable shares is a somewhat different matter. The preferred shares of a corporation whose preferred dividends are in arrears and are expected by investors to remain in arrears will normally sell at a substantial discount from their liquidation price. The less prosperous the corporation, the lower the price at which well-informed holders of redeemable preferred shares will consent to sell them. By using corporate capital to purchase such shares at low prices, the management will be able, at relatively slight cost, to eliminate dividend and liquidation claims which have priority over those of the common shareholders. Such a practice, pursued on a sufficiently large scale, may put the common shareholders in a position where even a very slight improvement in the corporation's earnings would make it possible to pay dividends on the common shares.¹⁰⁵

A legal rule which permits the practice may seem a dangerous one. It is the corporation's unprosperous state which makes it possible to buy the preferred shares at a low price, and this same unprosperous state will often be a sufficient reason why its financial condition should not be changed for the worse by the expenditure of a portion of its capital in the purchase of shares. Nevertheless, the risks involved in granting the power to make such purchases are probably more theoretical than real, since, for reasons already indicated, the managers are unlikely to make it unless they believe that it will leave the corporation with a substantial margin of assets over liabilities. The corporations which have most frequently engaged in this practice are the investment companies. Such companies usually have liquid assets and few debts. Even where they have been somewhat unsuccessful, they are still able to use part of their capital to purchase their preferred shares without seriously increasing their creditors' risks.

The Report of the Securities and Exchange Commission on Investment Trust and Investment Companies criticizes the practice of

105. For an illuminating account of purchases of preferred shares by investment companies, see REP. S. E. C., *supra* note 91, Pt. III, c. III, 211 *et seq.* The Report states that, during the period 1927-1935, the ratio of repurchases to original sales of the preferred shares of the "closed-end" management investment companies and investment-holding companies included in the Commission's study was 37 per cent.

purchasing the preferred shares of such companies at less than their liquidation value from a different angle. It makes the point that such purchases are unfair to the preferred shareholders, who thereby generally obtain much less than they would if the enterprise were liquidated and the entire assets, up to the amount of their liquidation preferences, were distributed to the preferred shareholders.¹⁰⁶ It is clear, however, that in this situation the preferred shareholders' difficulties are not primarily due to the management's power to purchase the preferred shares. They are due rather to the fact that the preferred shareholders usually have no power to compel the liquidation of the corporation, even where the assets are less than the amount of their liquidation preferences, and frequently have no power to oust a management despite its long-continued failure to declare dividends on the preferred shares. Under such circumstances, their only means of realizing anything on their investment is to sell their shares, either to the corporation or to someone else, at bargain prices.

It may be that our corporation statutes should standardize the preferred share contract to the extent of requiring that preferred shareholders should, under certain circumstances, be empowered to elect a majority of the directors and even to dissolve the corporation, or that the holders of such shares should be safeguarded by other types of protective provisions or by some form of regulation by administrative agencies,¹⁰⁷ but that is another story. It may be, also, that corporate directors and officers who are purchasing shares for the corporation should be under the same duty of full disclosure as some courts place upon them when they are buying shares for themselves, or that persons from whom the corporation is purchasing shares should receive some other form of protection,¹⁰⁸ but those are not questions peculiar to the purchase of redeemable preferred shares.

If, instead of discussing the question at large from the standpoint of economic and financial policy, we turn to the statutes and the

106. The writer of the Commission's Report apparently assumes that it is "improvident" for a senior security holder to sell at a discount where the value of the corporate assets exceeds the liquidation price of those shares, and suggests that the fiduciary relationship between management and security holder should lead the former to seek to deter the latter from such improvidence. REP. S. E. C., *supra* note 91, Pt. III, c. III, 212. The preferred shareholder in a closed-end investment trust normally has no way of obtaining the liquidation value of his shares if there is no market for the shares at that price, unless the management calls the preferred issue for redemption or the common shareholders vote to dissolve, neither of which events is likely to occur where the corporation is unsuccessful. The preferred shareholder who realizes that he is caught in a trap and surrenders to his captors on the best terms he can get may be a maltreated individual, but hardly an improvident one.

107. See the protective provisions for preferred shareholders required by Investment Company Act of 1940, § 18, 15 U. S. C. A. § 80a-18 (Supp. 1940).

108. Compare the restrictions imposed on all purchases of shares by "closed-end" investment companies by Investment Company Act of 1940, § 23, 15 U. S. C. A. § 80a-23 (Supp. 1940).

cases, we find that the situation with regard to redeemable preferred shares varies widely from state to state. In a large number of jurisdictions, the statutes contain no provisions whatever with regard to the issue of redeemable shares.¹⁰⁹ In this situation most courts have held that provisions in the articles of incorporation or by-laws or other corporate documents authorizing the issue of such shares are entirely proper.¹¹⁰ Many courts have gone further and held that, in the absence of any statutory prohibition, such shares may be redeemed out of the corporation's capital, provided the corporation is solvent and will not be rendered insolvent by the payment of the redemption price.¹¹¹ All or nearly all of these decisions have been made in jurisdictions in which there were at the time no statutory or common law limitations on the purchase of shares out of capital. If capital may be used for ordinary purchases, it would seem to be *a fortiori* true that it can be used for the retirement of shares described in a public document, which is the constitution of the company, as representing temporary contributions to capital that the corporation is authorized to repay.

109. Although this situation is less common than it was a few years ago, it still exists in a number of important jurisdictions, including Massachusetts and New York.

110. Consolidated Music Co. v. Brinkerhoff Piano Co., 64 F. (2d) 884 (C. C. A. 10th, 1933) (redemption provision in articles of incorporation); Weidenfeld v. Northern Pacific R. Co., 129 Fed. 305 (C. C. A. 8th, 1904) (same facts as Hackett case, *infra*); Coggeshall v. Georgia Land & Inv. Co., 14 Ga. App. 637, 640, 82 S. E. 156 (1914) *semble* (redemption provision in share certificate); Lindsay v. Arlington Co-op. Ass'n, 186 Mass. 371, 71 N. E. 797 (1904) (co-operative association; redemption provision in by-laws upheld); Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N. E. 383 (1933) (charter provision for redemption upheld; statute authorized the creation of preferred shares but did not mention redemption); Cohn v. Schultz-Costlow Co., Inc., 229 App. Div. 174, 241 N. Y. Supp. 250 (1st Dep't 1930) (foreign corporation; redemption provision in share certificate); Hackett v. Northern Pacific R. Co., 36 Misc. 583, 73 N. Y. Supp. 1087 (Sup. Ct. 1901) (option in corporation to retire its preferred shares not part of the charter but provided for by a shareholders' resolution, embodied in reorganization agreement and inserted in the share certificates).

111. Nearly all of the litigation has arisen with respect to shares which are redeemable at the option of the holder or on a fixed date. Booth v. Union Fibre Co., 137 Minn. 7, 162 N. W. 677 (1917) (provision in by-laws and share certificates that preferred shares should be redeemed on a fixed date held binding on demurrer, the case not being one "of a corporation purchasing its own stock or refunding to a shareholder capital unconditionally contributed by him"; on trial of the case, it appeared that the corporation was insolvent; recovery was therefore denied in Booth v. Union Fibre Co., 142 Minn. 127, 171 N. W. 307 (1919)); Consolidated Music Co. v. Brinkerhoff Piano Co., 64 F. (2d) 884 (C. C. A. 10th, 1933) (judgment for the plaintiff, a preferred shareholder who was suing on the corporation's promise to redeem, was affirmed; the corporation was in receivership in a state court, and the opinion points out that the judgment left the state court free to determine priorities as between the plaintiff and ordinary creditors); Cring v. Sheller Wood Rim Mfg. Co., 98 Ind. App. 564, 123 N. E. 674 (1932) (allegation by preferred shareholder, who was seeking to compel redemption, that redemption would leave the corporation solvent held sufficient); Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N. E. 383 (1933) (holders of class B preferred shares permitted to compel redemption although the effect would be to reduce the net assets to an amount much less than the par value and liquidation preferences of another class of preferred which was entitled to share equally with class B in case of liquidation or dissolution); Starek v. Marshall-Wells Co., 194 Minn. 564, 261 N. W. 398 (1935) (defense that redemption would prejudice the rights of creditors not made out by proof that the capital was slightly impaired); Ammon v. Cushman Motor Works, 128 Neb. 357, 258 N. W. 649 (1935) *semble*.

On the other hand, where the state statute forbids purchases which impair capital, or forbids all distributions of capital to shareholders, and is wholly silent as to the existence of a corporate power to issue redeemable preferred shares, there is force in the contention that redemption out of capital is impliedly forbidden. There is a case in New York which appears to take this view.¹¹² And in Minnesota, redemption out of capital is expressly forbidden.¹¹³

The statutes of many states do, however, specifically empower corporations to issue preferred shares which are subject to redemption.¹¹⁴ Although many of these statutes are silent as to the funds which may be used for redemption, it may well be contended that, in the absence of any contrary implications arising out of other statutory provisions, the phrase "redeemable shares" implies that the capital represented by those shares is retirable capital, and that accordingly such statutes impliedly authorize the use of capital for redemption purposes.¹¹⁵ In a few states this argument is strengthened by language in the section of the statute dealing with reduction of capital, which permits redeemable shares to be retired without complying with the formalities usually necessary for such reduction.¹¹⁶

In several states, including a number of the more important jurisdictions, the use of capital for redemption is explicitly authorized.

112. In *Greene v. Boardman*, 143 Misc. 201, 203, 256 N. Y. Supp. 340, 343 (Sup. Ct. 1932), *aff'd mem.*, 240 App. Div. 75, 265 N. Y. Supp. 965 (3d Dep't 1933), the use of capital to retire preferred shares was treated as a violation of § 58 of the New York Stock Corporation Law, which forbids distributions of capital to shareholders, but the court does not explicitly state that the preferred shares were made redeemable by their terms.

113. 3 MINN. STAT. (Mason, 1940 Supp.) § 7402-21-VI.

114. See the statutes cited in note 95, *supra*. Cf. KY. STAT. ANN. (Baldwin, 1936) § 564-1, providing that a corporation may give each class of shares "such priority of right . . . in the redemption of the shares as may be prescribed in the rules and regulations adopted by the shareholders"; PA. STAT. ANN. (Purdon, 1938) tit. 15, § 2852-602, recognizes the propriety of issuing redeemable shares by providing that there may be variations between different series of shares of the same class as to various matters, including "the price at, and the terms and conditions on, which shares may be redeemed".

115. Thus in Kentucky the courts, relying to some extent on the statute referred to in note 114, *supra*, have held that a solvent corporation must perform its contract to redeem even though its capital is impaired. *Westerfield-Bonte Co. v. Burnett*, 176 Ky. 188, 195 S. W. 477 (1917); *F. T. Gunther Grocery Co. v. Hazel*, 179 Ky. 775, 201 S. W. 336 (1918).

116. See CONN. GEN. STAT. (1930) tit. 35, § 3451, providing that preferred shares "may be subject to redemption", and § 3425, stating that "the provisions of law concerning reduction of capital stock and concerning a corporation acquiring its own stock shall not apply to the retirement of preferred stock" if the method of retirement is set forth in a certificate filed in the office of the secretary of state; NEV. COMP. LAWS (Hillyer, 1929) § 1624, as amended by L. 1939, c. 196, permitting corporations to reduce their capital without complying with the usual formalities required for such reduction, where the reduction is effected "by redeeming or purchasing preferred or special shares subject to redemption at not exceeding the price or prices at which the same may be redeemed"; TENN. CODE (Michie, 1938) § 3724, providing that all classes of shares may be made subject to redemption, and § 3736, providing for reduction of capital "by redeeming shares subject to redemption in the manner and not to exceed the consideration stated in the certificate of incorporation".

Some of the statutes provide that such redemption cannot be made if the assets remaining would be insufficient to pay the debts,¹¹⁷ or if there would be reasonable ground for believing that such redemption would make it impossible for the corporation to pay its debts as they fall due.¹¹⁸ A few, including that of Pennsylvania, add a restriction against the use of capital for redemption purposes if the remaining assets would be insufficient to cover both the debts and the liquidation preferences of any shares which are entitled on dissolution to priority over or equality with the shares which are to be redeemed.¹¹⁹ Under some of these statutory provisions, it would seem legally possible to use capital for the payment of the redemption premium as well as for the payment of the par value of the redeemed shares.

A number of modern statutes negate the latter possibility by providing that, after redemption, the remaining assets must equal the debts plus that part of the capital which has not been retired by means of the redemption,¹²⁰ or, as in Pennsylvania,¹²¹ that only the amount of capital which is represented by the shares to be redeemed may be used for that purpose.¹²² There is perhaps no very serious danger that corporate managements will use capital to pay premiums in connection with redemption of preferred shares where the circumstances are such that to do so would be seriously detrimental to the interests of creditors, the shareholders, or the enterprise as a whole. But it accords with sound accounting principles to insist that a corporation cannot lawfully engage in a redemption operation by which it expends a larger amount of its capital funds than the amount of capital liability which is written off by the retirement of the redeemed shares.

Some of the statutes specifically provide that redeemable shares may be purchased at not more than their redemption price and that capital may be used for such purchases to the same extent as for re-

117. W. VA. CODE ANN. (Michie & Sublett, 1937) § 3052. Similar provisions exist in some states which in addition impose restrictions on the amount of capital, per share, which may be used for redemption. DEL. REV. CODE (1935) c. 65, § 27; KAN. GEN. STAT. ANN. (Corrick, Supp. 1939) § 17-3220; MICH. STAT. ANN. (Henderson, 1936) c. 15, § 21.37. Cf. OHIO CODE ANN. (Throckmorton, 1940) § 8623-41 (forbidding redemption if there is "reasonable ground for believing that the corporation is unable, or by such purchase may be rendered unable, to satisfy its liabilities").

118. CAL. CIV. CODE (Deering, 1937) § 342; Illinois, 5 JONES STAT. ANN. § 32.058; PA. STAT. ANN. (Purdon, 1938) tit. 15, § 2852-705. All of these statutes contain additional restrictions.

119. See the California, Illinois, and Pennsylvania statutes cited in note 118 *supra*.

120. MD. ANN. CODE (Flack, 1939) art 23, § 54; WASH. REV. STAT. ANN. (Remington, 1932) § 3803-40½.

121. PA. STAT. ANN. (Purdon, 1938) tit. 15, § 2852-705.

122. DEL. REV. CODE (1935) c. 65, § 27 (a substantially similar but more elaborate provision); KAN. GEN. STAT. ANN. (Corrick, Supp. 1939) § 17-3220 (similar to Delaware); LA. GEN. STAT. ANN. (Dart, 1939) § 1125; MICH. STAT. ANN. (Henderson, 1936) c. 15, § 2137; MO. STAT. ANN. (1932) § 4952c; N. J. STAT. ANN. (1939) tit. 14, § 8-3.

demption.¹²³ Even in the absence of such provisions, it is unlikely that a court would hold that a corporation which is authorized by law to call its shares for redemption at \$110 a share and to use its capital in that operation to the extent of \$100 a share, cannot lawfully expend the same or a lesser amount of capital in purchasing the same shares from holders who are willing to sell them.¹²⁴

Compulsorily Redeemable Preferred Shares

From the standpoint of the corporation, preferred shares are compulsorily redeemable not only when the corporation promises to redeem them at a fixed date or on the happening of a contingency, but also when it gives the holder an option to demand redemption. Of these various types of redemption provisions, those which make the shares redeemable at the holder's option are both the most common and the most objectionable. The holder of such shares will be most likely to exercise his option to demand the return of his capital if he believes the corporation is unsuccessful. A corporation which has such shares outstanding is, therefore, subject to the burden of having to pay out part of its capital under circumstances where to do so may be highly detrimental to the fortunes of the enterprise and extremely injurious to the interests of the creditors and to the holders of other classes of shares. Even though such provisions are generally held to be unenforceable where the corporation is actually insolvent, they nevertheless have a strong tendency to compel an unsuccessful enterprise to enfeeble itself still further through repayment of part of its capital. However tolerable where the corporation is an investment company whose business is merely to purchase and hold a pool of liquid securities,¹²⁵ such provisions are loaded with dynamite when made use of in the financing of industrial enterprises which cannot

123. CAL. CIV. CODE (Deering, 1937) § 342 (5); DEL. REV. CODE (1935) c. 65, § 27 (applicable also to the purchase of preferred shares which are not subject to redemption); MD. ANN. CODE (Flack, 1939) art. 23, § 54 (2) (7); MO. STAT. ANN. (1932) § 4952c (similar to Delaware); W. VA. CODE ANN. (Michie & Sublett, 1937) § 3034 (probably applicable to the purchase of preferred shares which are not subject to redemption).

124. The Michigan legislature has, however, made a distinction between the redemption and the purchase of redeemable shares, permitting the capital to be used for the former purpose but not for the latter. MICH. STAT. ANN. (Henderson, 1936) c. 15, § 21.37.

125. The effect of the Investment Company Act of 1940 is to permit management investment companies to issue shares which are redeemable at the option of the holder only where the company has no more than one class of shares, thus making it legally impossible for such companies to issue preferred shares which are redeemable at the holder's option. This results from the combined effect of § 5, which classifies a company that issues "any redeemable security" as an "open-end" company, § 2 (a) 31, which provides that "redeemable security" means a security which entitled the holder to present it to the issuer and receive approximately his share of the net assets or their cash equivalent, and § 18 (f), which forbids "open-end" companies, with minor exceptions, to issue senior securities.

function successfully if a substantial part of their capital is subject to sudden withdrawal. It is immaterial that, where redemption provisions of this sort are part of the corporation's charter, the common shareholders have in theory assented to them and that the creditors have constructive notice of them. The day has passed when it is possible to take seriously the argument that the legislature, without whose aid business corporations cannot exist, should sanction wholly unsound methods of financing them, merely because those whose interests are most directly involved are put on notice that such methods have been used.

Preferred shares which are redeemable at the option of the holder are dangerous to the corporation, its creditors, and the holders of other classes of its shares. They are objectionable for the further reason that they are likely to mislead the person who purchases the redeemable shares. Although they purport to entitle the shareholder to demand his money at any time, the courts, properly insisting that a fundamental rule of corporation law prevents shareholders from competing with creditors in cases of corporate insolvency, have held that they cannot be enforced against insolvent corporations.

Unfortunately, the investor most likely to invest in the shares of corporations whose preferred stock is so difficult to sell that it needs window dressing of this kind is the sort of person who cannot easily be made to understand that an apparently absolute promise of repayment is subject to legal restrictions based on the nature of shareholding as a proprietary rather than a creditor interest. Out of regard for the interests of the preferred shareholder himself, as well as those of the corporation and its creditors, the issue of such shares should, therefore, be made illegal, and adequate measures should be taken by blue-sky commissions or other appropriate public bodies to prevent shares purporting to create redemption rights of this sort from getting into the hands of the public.¹²⁶ Although shares which are redeemable at a fixed date or on a contingency are not quite as injurious as shares which are redeemable at the option of the holder, they are subject to much the same objections and should not be permitted. An

126. See *Koeppler v. Crocker Chair Co.*, 200 Wis. 476, 483, 484, 228 N. W. 130 (1930). Even where there is no statute making such shares illegal, a blue-sky commission which, like that of Michigan, has power to refuse a license to sell securities "where it appears to the commission that the sale of such securities would work a fraud, deception or imposition on purchasers or on the public, or that the proposed disposal of the securities is on unfair terms", MICH. COMP. LAWS (Mason, Supp. 1940) § 9780, might refuse to permit such shares to be issued without an explicit statement in the prospectus that redemption rights are subordinate to the claims of creditors in case of insolvency, or might even deem itself authorized to refuse to permit them to be issued at all. The full disclosure requirements of the Securities Act of 1933, 15 U. S. C. A. § 77a *et seq.* (Supp. 1940), might also affect the situation.

exception may well be made in the case of shares which are to be redeemed out of a sinking fund to be set up out of earnings.

It is to be regretted that not more than two or three states have expressly forbidden the issue of shares of these types.¹²⁷ It is conceivable that the phrase "subject to redemption", which is very commonly used in statutes authorizing the issue of preferred shares, might be held to apply only to shares that subject the holder to the risk of having his shares redeemed against his will¹²⁸ and thus not to sanction the issue of shares that give the holder the privilege of demanding the return of his investment. The question is, however, unlikely to arise except in the case in which shares which purport to grant the holder an option to redeem have been issued and purchased by confiding investors. Under these circumstances, it is improbable that a court would feel justified in resting a decision invalidating the redemption provision on so tenuous a ground. Moreover, in a few states, the legislature has expressly authorized both the issue of shares of this type and the use of corporate capital in the performance of the corporation's promise to redeem them.¹²⁹

Nearly all of the litigation with respect to compulsorily redeemable shares has arisen in jurisdictions in which there are no statutory restrictions either on the issue of such shares or on the funds which are available for the performance of the redemption agreement. As has been previously stated, the courts are unanimous in holding that such agreements are enforceable only if the corporation is solvent at the time when the option to redeem is exercised.¹³⁰ The existence of

127. CAL. CIV. CODE (Deering, 1937) § 294, provides that any right of redemption shall be exercisable at the option of the corporation only, except that provision may be made for the compulsory redemption of shares out of a sinking fund accumulated out of net earnings. FLA. COMP. LAWS ANN. (Skillman, 1927) § 6535, provides that shares "may be subject to such rights of redemption reserved to the corporation as may be stated" in the certificate of incorporation.

128. Compare the construction given to the redemption provisions of a Michigan statute, since repealed, in *Ellsworth v. Lyons*, 181 Fed. 55, 59 (C. C. A. 6th, 1910).

129. MD. ANN. CODE (Flack, 1939) art. 23, § 42; OHIO CODE ANN. (Throckmorton, 1940) § 8623-4.

130. For cases refusing to allow a holder of redeemable shares to recover the redemption price from an insolvent corporation or one not shown to be solvent, see *Spencer v. Smith*, 201 Fed. 647 (C. C. A. 8th, 1912) (corporation bankrupt); *Rider v. Delker & Sons Co.*, 145 Ky. 634, 140 S. W. 1011 (1911) (corporation insolvent; petition by holder of redeemable shares for receiver denied); *Booth v. Union Fibre Co.*, 142 Minn. 127, 171 N. W. 307 (1919) (corporation insolvent though not in liquidation); *Koeppler v. Crocke Chair Co.*, 200 Wis. 476, 228 N. W. 130 (1930) (burden on shareholder demanding redemption to show that assets exceed liabilities). See *Warren v. Queen & Co.*, 240 Pa. 154, 160, 87 Atl. 595 (1913).

In *Ellsworth v. Lyons*, 181 Fed. 55 (C. C. A. 6th, 1910), a solvent corporation took out an insurance policy on the life of its president for the purpose of providing a fund for the retirement of its preferred shares, and, while still solvent, paid the premiums on the policy. The court held that the corporation's trustee in bankruptcy and not the preferred shareholders were entitled to the cash surrender value of the policy. *But cf.* *Tweedie Footwear Corp. v. Fonville*, 115 S. W. (2d) 421 (Tex. Civ. App. 1938).

such a rule makes it necessary to distinguish sharply between instruments creating redeemable preferred shares and instruments creating indebtedness. Unhappily, the distinction is one which is often difficult to make, since it is a not uncommon practice for corporations to issue securities in which the ordinary attributes of debt and of shareholder-ship are blended together, perhaps for the very purpose of enabling the holder to claim shareholder's rights if the enterprise prospers and creditor's rights if it does not. A majority of the courts have tended to resolve such ambiguities in favor of shareholdership.¹³¹

Difficult questions arise where the corporation, although solvent at the time when the right of redemption accrues, becomes insolvent before payment is made. If the shares are redeemable on demand, can a creditor status, which will enable a former shareholder to prove with other creditors against a company which is now bankrupt or insolvent, be acquired by making demand, by bringing suit, by recovering judgment,¹³² or by receiving the corporation's bond or promissory note,¹³³ provided that the corporation was still solvent when these events occurred? If the shares are to be redeemed on a fixed date, does their owner automatically become a creditor on that date without any action on his part, if the corporation is still solvent at that time but later becomes insolvent?¹³⁴

131. *Mathews v. Bradford*, 70 F. (2d) 77 (C. C. A. 6th, 1934); *In re Hicks-Fuller Co.*, 9 F. (2d) 492 (C. C. A. 8th, 1925); *Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc.*, 8 F. (2d) 716 (C. C. A. 2d, 1925); *Armstrong v. Union Trust & Savings Bank*, 248 Fed. 268 (C. C. A. 9th, 1918); *Spencer v. Smith*, 201 Fed. 647 (C. C. A. 8th, 1912); *Ellsworth v. Lyons*, 181 Fed. 55 (C. C. A. 6th, 1910); *Young v. Lyons Milling Co.*, 124 Kan. 83, 256 Pac. 717 (1927); *Booth v. Union Fibre Co.*, 142 Minn. 127, 171 N. W. 307 (1919). *But cf.* *Savannah Real Estate, etc., Co. v. Silverburg*, 108 Ga. 281, 33 S. E. 908 (1899); *Best v. Oklahoma Mill Co.*, 124 Okla. 135, 253 Pac. 1005 (1926). See Uhlman, *The Law of Hybrid Securities* (1938) WASH. U. L. Q. 182.

132. The question of the effect of obtaining such a judgment was left open in *Vanden Bosch v. Michigan Trust Co.*, 35 F. (2d) 643 (C. C. A. 6th, 1929).

133. In *In re Phoenix Hotel Co.*, 83 F. (2d) 724 (C. C. A. 6th, 1936), *cert. denied*, 299 U. S. 568 (1936), a Kentucky corporation issued preferred shares convertible into bonds, such shares being provided for by statute. The shareholders later demanded and received bonds in exchange for their shares, and some time later the corporation filed a reorganization petition under § 77B of the Bankruptcy Act. The court held that the claims of the bondholders should be postponed to those of persons who had lent credit to the corporation prior to the conversion. The decision was based in part on a statute providing that the rights of creditors should not be lessened by a decrease in the capital stock of any corporation.

But cf. *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932), in which the claim of one who had exchanged his redeemable shares for the corporation's note was held valid in the subsequent receivership of the corporation, the court relying to some extent on the fact that the record did not show the existence of any creditors whose claims antedated the giving of the note.

The Investment Company Act of 1940, § 18e, forbids any company subject to that Act to issue a senior security which represents indebtedness for the purpose of refunding any senior security which is a stock.

134. The Circuit Court of Appeals for the Sixth Circuit has twice answered this question in the negative. *Vanden Bosch v. Michigan Trust Co.*, 35 F. (2d) 643 (C. C. A. 6th, 1929), cited note 132, *supra*; *Mathews v. Bradford*, 70 F. (2d) 77 (C. C. A. 6th, 1934), cited note 131, *supra*.

There are a number of decisions on these and similar questions, some of which have given rise to a considerable amount of adverse criticism.¹³⁵ For reasons similar to those which have been stated in the portion of this article which deals with purchase of shares, the writer's inclination would be to deny the preferred shareholder's claim to equality with the creditors in all of these situations. The controversy is, however, one in which it seems wise to remain, if not strictly neutral, at least non-belligerent. If the law permits business corporations to spawn financial cats and dogs, it will be faced with difficult problems in attempting to weigh the claims of the unfortunate shareholder who has been sold a pup, against those of the creditor who insists that he is in danger of being bitten unless the pup is given a dose of chloroform. What is needed is not a formula for adjudicating such disputes, but an efficient method of preventing the breeding and sale of these animals. Investment companies with liquid assets and few debts may properly be permitted to issue shares which are redeemable at the option of the holder but an enlightened system of corporation law would not allow corporations which are engaged in active business operations to court financial disaster by obtaining their capital on such terms.

135. See Jones, *Redeemable Corporate Securities* (1931) 5 So. CALIF. L. REV. 83; Note (1935) 83 U. OF PA. L. REV. 888; Note (1930) 28 MICH. L. REV. 888.