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CORPORATE PURCHASE OF ITS OWN SHARES—ARE THERE NEW OVERTONES?

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The leading case of *Trevor v. Whitworth*[1] established as the law of England the rule that a corporation could not properly go into the market and purchase its own shares. If it bought them for resale it would be "trafficking in shares" rather than engaging in the business for which it was chartered. If it bought them for retirement it would be unlawfully reducing capital without the court approval required by the Companies Act.

Trevor was not long followed in the United States. American statutes and decisions today generally sanction a corporate purchase of its own shares if made "out of surplus" or "out of earned surplus," or forbid it only if capital is impaired or the purchase will impair capital. Where shares are by their terms redeemable (as are most preferred issues) their purchase is generally permitted not only out of surplus but out of capital as well, unless at the time of purchase the corporation is insolvent (*i.e.*, unable to meet its debts as they mature in the ordinary course of business), or the purchase will render it insolvent.[2]

Granting the existence of clear corporate power to make the purchase, the principal questions are the manner and propriety of its exercise. To begin with, unless corporate or shareholders' interest generally is served, the action would seem at least improvident. Thus, at a minimum we posit a situation where the shares are obtainable either privately or in the open market at a demonstrably advantageous price, typically so far below a conservatively computed book value that retirement would reflect a significant addition to the equity of the remaining shareholders. Conceivably there might also be the rare case of a pur-

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1 12 App. Cas. 400 (1887).

2 Typical of the modern statutory approach are § 513 of the N.Y. Bus. Corp. Law and § 5 of the ABA-ALI Model Bus. Corp. Act (1960). These statutes cover both of the aspects mentioned and also permit purchases for the purpose of eliminating fractional shares, collecting or compromising indebtedness due the corporation or in satisfaction of the appraisal rights of shareholders dissenting from a merger, consolidation or material amendment to the certificate of incorporation. Older New York cases cast doubt upon the enforceability of the corporation's contractual obligation to purchase its own shares for possible lack of "mutuality" because there might be no available surplus when the obligation matured. N.Y. Bus. Corp. Law § 514 specifically overrules these cases, stating the rule in precisely opposite terms: the obligation is specifically enforceable to the extent that "at the time for performance" the purchase would be proper under § 513.

chase so far below current market value as to assure corporate benefit from resale, *e.g.*, in satisfaction of outstanding warrants or options. As between a private and an open market purchase, unless the seller is a "controlling person," an officer, a director, or otherwise an "insider," the choice may properly be made on a price basis. Arguably, where a large block is involved, a premium over market, reflecting what presumably would be the inflationary effect of a large "buy order," may perhaps be justified.

Where the seller is an insider the questions are at once more complicated. Does the transaction arguably represent an opportunity to market an otherwise unmarketable block of shares, or one which at a minimum would be difficult to market at the price? Is there an obligation to make available pro rata to all shareholders whatever advantage may be inherent in such a transaction? If that is done, is the vice cured? There seems to be widespread opinion among corporate counsel that there is such an obligation, as witness the number of cases in which the insider sells only as one who has contracted to tender a specified number of shares at a specified price under a procedure open pro rata to all shareholders.

Where the general body of shareholders are the potential sellers, questions may well arise as to the adequacy of the information made available to them as the basis on which they will determine whether or not to sell. At least where the procedure is direct tender to the corporation, it seems quite clear that under section 10(b) of the Securities Exchange Act of 1934[3] and the SEC's Rule 10b-5 thereunder[4] the corporation as potential purchaser stands in a fiduciary relation to its shareholders and must make adequate disclosure.[5] Thus under some circumstances the procedure might even require some sort of "reverse prospectus."[6]

Where the purchases are made on the open market this aspect is less

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[3] 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958).

[4] 17 C.F.R. § 240.10b-5 (1942). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

There is no longer any doubt that breach of the rule gives rise to a civil cause of action enforceable in the federal courts. J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

[5] Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962); Ward La France Truck Corp., 13 S.E.C. 373 (1943).

[6] Cf. Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

clear. At least there is no necessary contractual "privity" between buyer and seller which, until comparatively recently, was thought prerequisite to the establishment of liability under Rule 10b-5.[7]

Suppose the shares of Corporation A are selling at eleven. The corporation pursuant to a resolution of its board proceeds to make heavy market purchases of its own shares. Indeed such purchases are the principal factor in the market over a period of months, at the end of which the shares are selling at twenty. The corporation then announces that it will receive direct tenders of 100,000 shares at twenty-one and one-half. Could a shareholder who had sold a thousand shares at twelve (whether or not the corporation was in fact the purchaser) properly complain that he should at least have been advised in advance of the corporation's projected buying program, because had he been, he would have held on at least until the floating supply was gathered in and the price stabilized at a higher level?

Suppose then that X, a controlling person of the corporation, proposes to tender 50,000 shares, some of which he acquired by market purchases seven to nine months previously—perhaps just prior to the corporation's entry into the market. Could it be urged that X had seized a corporate opportunity and should account for his profit on the tendered shares?[8] Suppose X knows of facts, as yet unreported to shareholders generally, indicating that the corporation had suffered losses which when publicized in the ordinary course are likely to cause a break in the market price of the shares? Can the corporation rescind its purchase of the 50,000 shares that X had tendered? A recent case in the Court of Appeals for the Seventh Circuit, though decided on other grounds, suggests that possibility.[9]

Purchases made deliberately for the sole or incidental purpose of affecting control of the corporation raise another set of questions. In a close corporation context the device may be particularly useful, enabling a homogenous group of shareholder-managers to use corporate funds to rid themselves of a discordant element, perhaps to break a deadlock and

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[7] Since Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962), contractual "privity" is probably no longer a necessary element of the cause of action.

[8] Compare § 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958), under which X would be liable for any "short-swing profit," with the reluctance of courts to define "corporate opportunity" in terms of a purchase of shares. Hauben v. Morris, 255 App. Div. 35, 5 N.Y.S.2d 721 (1st Dep't 1938), aff'd mem., 281 N.Y. 652, 22 N.E.2d 482 (1939); Mannheimer v. Keehn, 30 Misc. 2d 584, 41 N.Y.S.2d 542 (Sup. Ct. Monroe County 1943), modified and aff'd, 268 App. Div. 813, 49 N.Y.S.2d 304 (4th Dep't 1944). But see Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (Ch. 1949); Lewin v. New York Ambassador, Inc., 61 N.Y.S.2d 492 (Sup. Ct. N.Y. County 1946), aff'd mem., 271 App. Div. 927, 67 N.Y.S.2d 706 (1st Dep't 1947).

[9] Surowitz v. Hilton Hotels Corp., CCH Fed. Sec. L. Rep. ¶ 91,498 (7th Cir. 1965).

thus effectively substitute for dissolution.[10] In a public-issue corporation the case would seem quite different. The reasoning of the decided cases is to say the least parlous—and reveals no clear rationale. A Wisconsin court more than fifty years ago faced the contention of a minority shareholder that the corporate purchase of a portion of an insider's shares, though authorized by the board and ratified by the shareholders, was, by reducing the number of outstanding shares, primarily aimed at giving defendant directors a majority and thus control. The court, rejecting the contention, found the proof insufficient. There was, however, a vigorous dissent, and today the case probably stands for the proposition that a purchase demonstrably made to maintain control is an abuse of corporate power and thus a breach of fiduciary responsibility.[11]

A Massachusetts court in 1950 held a corporate purchase designed to give the directors control by reducing the total number of shares outstanding to be a breach of the directors' fiduciary duty,[12] by analogy to cases forbidding the resale of treasury shares to friendly purchasers in order to ensure continuing control in the management group.[13]

Four Delaware decisions present the other side of the coin.[14] All four opinions pay lip service to the principle that a purchase made "solely" or even "primarily" for the purpose of maintaining control is a breach of the directors' fiduciary duty. However in three of the four cases the courts have sustained the directors' defenses on the theory that a threat to control by an "outsider" poses a question of "corporate policy" in terms of conflicting views as between management and a large "outside" interest as to how the business should be conducted in the future. Normally one would expect such questions to be determined by the shareholders at the polls. On that theory the courts have permitted management to defend its "policies" in proxy contests at corporate expense[15] and have sanctioned corporate reimbursement of the expenses of successful insurgent shareholders.[16]

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10 Cf. Israels, "The [Law Revision] Commission and the Corporation Laws," 40 Cornell L.Q. 686, 692 (1955); Israels, "The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution," 19 U. Chi. L. Rev. 778 (1952).

11 Gilchrist v. Highfield, 140 Wis. 476, 123 N.W. 102 (1909).

12 Andersen v. Albert & J. M. Anderson Mfg. Co., 325 Mass. 343, 90 N.E.2d 541 (1950).

13 Elliott v. Baker, 194 Mass. 518, 80 N.E. 450 (1907); cf. Macht v. Merchants Mortgage & Credit Co., 22 Del. Ch. 74, 194 Atl. 19 (Ch. 1937); see Bowen v. Imperial Theatres, Inc., 13 Del. Ch. 120, 129, 115 Atl. 918, 922 (Ch. 1922).

14 Cheff v. Mathes, 199 A.2d 548 (Del. 1964); Bennett v. Propp, 187 A.2d 405 (Del. 1962); Martin v. American Potash & Chem. Corp., 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960).

15 Hall v. Trans-lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch. 1934); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

16 Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp., supra note 15.

Citing this analogy the Chancellor in *Kors v. Carey*[17] upheld management's "defense" of its "policies" at corporate expense by purchase of the opposition's shareholdings at a premium price.

The latest Delaware decision, *Cheff v. Mathes*,[18] treats the premium purchase of "opposition" shareholdings as one of ordinary "business judgment" as to which the directors could do what they pleased so long as they acted in good faith and after investigation sufficient to convince them that there was "a reasonable threat to the continued existence of [the corporation] or at least existence in its present form."[19] In the *Bennet* case, which went the other way, the Supreme Court found there was "no immediate indication" that the outside interest would start to buy large numbers of shares in the market; therefore management's action in making large purchases for the corporation had been "illegal."[20] Clearly in the court's view the sin was not the purchase. It was having acted precipitately—without evidence of clear and present danger. *Kors* and *Cheff* stand clearly for the proposition that directors of a Delaware corporation, once convinced that control is threatened by an outside interest which arguably would advocate some change classifiable with any verisimilitude as "policy," can decide a priori that such change would not be in the best interests of all the shareholders. Having so decided, they may with impunity proceed to make substantial expenditures of corporate funds to acquire at premium prices sufficient shares to assure that the general body of shareholders will be deprived of all opportunity effectively to exercise their franchise.[21]

Only one reported New York case seems to have involved a similar issue. In *Lawrence v. Decca Records, Inc.*,[22] one of several charges put forward in a derivative action for waste and mismanagement was the use of corporate funds to purchase its own shares (and thereby bolster management's control) at a time when the corporation needed the money for other purposes. The court held the allegation "for pleading purposes sufficient to survive the application of the business judgment rule."

O'Neill v. Maytag[23] raises the interesting question of the availability

[17] 39 Del. Ch. 47, 51, 158 A.2d 136, 140-41 (Ch. 1960).

[18] 199 A.2d 548 (Del. 1964).

[19] Id. at 555-56.

[20] Bennett v. Propp, 187 A.2d 405 (Del. 1962). Only the chairman who made the purchases without board approval was held liable. Recognizing that the general rule is that "directors who use corporate funds to preserve control commit a wrong," the court nevertheless absolved the remaining members of the board who had merely voted to ratify the chairman's acts on the basis of "prior ignorance and immediate emergency." Id. at 411.

[21] Cf. Berle, "Corporate Powers as Powers in Trust," 44 Harv. L. Rev. 1049 (1931); Israels, "Are Corporate Powers Still Held in Trust?" 64 Colum. L. Rev. 1446 (1964).

[22] 27 Misc. 2d 445, 203 N.Y.S.2d 225 (Spec. T. Sup. Ct. N.Y. County 1960).

[23] 339 F.2d 764 (2d Cir. 1964).

of a remedy under Rule 10b (5) in this context. National Airlines and Pan American World Airways were ordered by the Civil Aeronautics Board to terminate the existing "cross ownership" of each other's shares. They chose to accomplish this by an exchange rather than by sale in the market. National thus acquired 390,000 of its own shares (twenty-one per cent of the total outstanding) on a basis which at current New York Stock Exchange prices reflected the payment of a premium of approximately $1,800,000 to Pan American. The transaction was attacked under the rule as designed to get a large block of National shares off the market and thus solidify management's control. Apparently, the theory was that the transaction was either a "device, scheme, or artifice to defraud," or an "act, practice, or course of business which operates or would operate as a fraud or deceit upon" the corporation.[24] In *Ruckle v. Roto Am. Corp.*,[25] decided only a few weeks before *O'Neill*, the court of appeals had found that the majority of the directors of a corporation, who through concealment of material facts at a directors' meeting had caused the corporation to sell treasury shares to enable the president to perpetuate his controlling position, were accountable under the rule; in effect that the claim that a corporation was induced by its controlling directors to sell shares for an inadequate consideration as part of a scheme to maintain control, stated a cause of action under the rule. Nevertheless in *O'Neill* a majority of the court (Judges Lumbard and Marshall) thought the rule inapplicable; in effect that a claim that a corporation was induced by controlling directors to buy shares for excessive consideration as part of a scheme to maintain control, failed to state a cause of action of the type contemplated by the rule, absent some "claim of deceit, withheld information or misstatement of material fact."[26]

The rule in two of its three subdivisions speaks in terms of a "device, scheme, or artifice to defraud"; and of an "act, practice, or course of business which operates or would operate as a fraud or deceit."[27] On the other hand the statute under which the rule was promulgated speaks only in terms of a "manipulative or deceptive device or contrivance,"[28] and thus arguably justifies the court's narrower construction of the rule.

However, even adopting the court's premise that to sustain a cause of action under the rule, some form of "deceit" of the corporation had to be shown, the soundness of the decision is open to argument, at least in

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24 17 C.F.R. § 240.10b-5 (1942).
25 Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964).
26 O'Neill v. Maytag, 339 F.2d 764, 767 (2d Cir. 1964).
27 17 C.F.R. § 240.10b(5)(a), (c).
28 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958).

terms of its consistency with the *Ruckle* case.[29] It is true, of course, that in *Ruckle* there were two directors who did not know the facts, whereas in *O'Neill* presumably all of the directors knew the facts. The facts in each case were the purpose or motivation for a transaction in securities. Since motivation is personal to management and thus potentially in conflict with fiduciary duty to the corporation, its concealment may properly be classified as a "deceit."

Nor is the key found by counting the noses of the directorate to see which may be clean. If it is possible to "deceive" the corporation by concealment of the purpose of a transaction in securities from a minority of the board of directors, it is equally possible to "deceive" it even where every member of the board knows all of the facts. To begin with there is the established principle of the law of agency that since a corporation acquires knowledge only through communication from individuals, knowledge acquired by individuals which it is in their personal interest to conceal, is not imputable to the corporation.[30] Then there are the limitations cases, arising under statutes which begin to run from the date on which "the aggrieved party" acquires knowledge or should reasonably have acquired knowledge of the facts. In general these cases refuse to impute to corporations knowledge held by wrongdoing directors, and in some cases refuse to impute it even though new directors come on the board so long as a majority of wrongdoers remains in control.[31] Apposite also would be the famous opinion of Chief Justice Rugg of the Supreme Judicial Court of Massachusetts in *Old Dominion Copper Mining & Smelting Co. v. Bigelow.*[32] The case was one seeking recovery of promoters' "secret profits" obtained in a transaction approved by unanimous action of the board at a time when the defendant promoters not only constituted the entire membership of the board of directors, but were the beneficial owners of all of the then outstanding shares. Nevertheless an action instituted in behalf of the corporation to benefit its public stockholders, who necessarily became such considerably after the transaction, was sustained. The gravamen was clearly "that type of . . . fraudulent practice usually associated with the sale or purchase of securities,"[33] and the

29 Ruckle v. Roto Am. Corp., supra note 25. Judge Hays dissented in O'Neill v. Maytag, supra note 26, at 770, but did not spell out his reasoning.

30 See, e.g., American Nat'l Bank v. Miller, 229 U.S. 517 (1913); Anderson v. General Am. Life Ins. Co., 141 F.2d 898 (6th Cir. 1944); In re L. Van Bokkelen, Inc., 7 F. Supp. 639 (D. Md. 1934).

31 There are illustrative New York and federal cases among those collated in a footnote by Circuit Judge Clark in Michelsen v. Penney, 135 F.2d 409, 416 n.2 (2d Cir. 1943).

32 203 Mass. 159, 89 N.E. 193 (1909).

33 Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir.), cert. denied, 343 U.S. 956 (1952), quoted by Judge Lumbard in ONeill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964).

court's emphasis throughout the opinion is on the concealment aspect. It seems to the writer plainly arguable that in *O'Neill* there was at least as much "concealment of material facts" from National Airlines as there was from the Old Dominion Copper Company in *Bigelow*.

Clearly there is an increasing volume of civil litigation under the federal Securities Acts, involving in the main implied rights of action under Rule 10b-5 and other "antifraud provisions."[34] Where the corporation is a defrauded purchaser of its own securities, resort to an implied cause of action may not be necessary. Section 12(2) of the Securities Act of 1933[35] provides a direct remedy against the seller of securities, whether or not registered, who makes the sale by means of a "prospectus or oral communication" which contains a misleading statement, either as misrepresentation or as half-truth. One may venture the prediction that there will be further litigation involving corporate purchases of their own shares, not only under the federal acts but in state courts as well, and that at least in jurisdictions less management-oriented than Delaware, the current federal tendency toward strict enforcement of managerial fiduciary obligation[36] will be reflected in some state decisions.

34 See Posner, "Developments in Federal Securities Regulations," 20 Bus. Law. 595, 604 (1965).

35 48 Stat. 74 (1933), 15 U.S.C. § 77l(2) (1958).

36 Cf. Friendly, "In Praise of Erie—And of the New Federal Common Law," 19 Record of N.Y.C. Bar Ass'n 64, 85-86 (1964).