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THE POWER OF A CORPORATION TO PURCHASE ITS OWN STOCK AND SOME RELATED PROBLEMS

The problem of whether or not a corporation may purchase its own stock is not a new one.¹ Lengthy and learned dissertations have been written upon this subject, most of which resolve themselves into two different schools of thought with minor modifications. These two views are commonly known as the "English Rule" and the "American Rule".

The "English Rule" holds on grounds of policy that a corporation cannot without express authority in its charter, or in the general statute under which it was organized, purchase its own stock, whether its purpose is to reissue or retire it, and such a transaction can be set aside at the instance of a creditor.² The reason for this rule is that there is too great a danger of fraud being perpetrated upon, or of injury and loss resulting to, the creditors. This rule has been followed in some states, both in statutes and case decisions.³

The "American Rule" takes the opposite view, namely that a corporation, in the absence of a constitutional, statutory, or charter provision prohibiting it, has the implied power to purchase its own stock.⁴ However, this is usually qualified by judicial decisions or statutes stating that purchases may be made: "out of surplus",⁵ "if

¹ *Hartridge v. Rockwell*, R.M. Charl. 260 (Ga. 1828); *Trevor v. Whitworth L.R.*, 12 App. Cas. 409 (H.S. 1887).

² *Trevor v. Whitworth L.R.*, 12 App. Cas. 409 (H.S. 1887); *Cook on Corporations*, 8th Ed., Sec. 309, p. 1027.

³ *Kansas*: *German Sav. Bank v. Wulfekuhler*, 19 Kan. 60 (1877); *Steele v. Telephone Ass'n.*, 95 Kan. 580 (1915); *Kelly v. Insurance Co.*, 101 Kan. 91, 165 Pac. 806 (1917). *New Hampshire*: *Latulippe v. New England Investment Co.*, 77 N.H. 31, 86 Atl. 361 (1913); *Currier v. Lebanon Slate Co.*, 56 N.H. 262 (1875). *Washington*: *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 Pac. 1155 (1913). *Wyoming Stat. Sec. 5056* (1920); *Kentucky Stat., Carrol, Sec. 554*. *Maryland, Missouri, Ohio and Tennessee* applied this rule before the enactment of statutes giving the corporation the power to acquire its own stock.

⁴ By the great weight of authority, a corporation has the right to buy its own stock. 6 *Fletcher, Cyclopedia Corporations*, perm. ed., Sec. 2848 (1931). *Davies v. Montana Auto Finance Corp.*, 86 Mont. 500, 284 Pac. 267 (1930), *Barrett v. W. A. Webster Lumber Co.*, (Mass.) 175 N.E. 765 (1931), citing in re *Fechheimer Fishel Co.*, 212 Fed. 357 (1914); *O'Brien Mercantile Co., v. Bay Lake Fruit Growers' Assn.*, (Minn.) 226 N.W. 513 (1929); *First Trust Co. v. Illinois Central R. Co.*, 270 Pa. 547, 113 Atl. 569 (1921); *Clapp v. Peterson*, 104 Ill. 26. (1882); *Burnes*, 137 Fed. 378. (1905); *Porter v. Plymouth Gold Min. Co.*, 29 Mont. 347, 74 Pac. 938 (1904); *Steele v. Farmers' & Merchants' Mutual Tel. Assn.*, 95 Kan. 580, 148 P. 661 (1915); *State ex rel Howland v. Olympia Veneer Co.*, 138 Wash. 144, 244 Pac. 261. (1926); *Mancine v. Patrizi*, 87 Cal. App. 435, 262 Pac. 375 (1927).

⁵ *Richards v. Weiner Co.*, 207 N.Y. 59, 100 N.E. 592. (1912); *Otsego Paper Stock Co. v. Slosberg*, 230 Mich. 260, 202 N.W. 991. (1925); *In re O'Gara & Maguire*, D. C. N.J., 259 F. 935, (1919); *Freater New York Carpet House v. Herschmann*, 258 App. Div. 649, 17 N.Y.S. (2d) 483 (1940). *Florida Statutes*, sec. 612.08 (1941); *South Dakota Rev. Code*, sec. 11.0303 (1939).

the capital is not impaired thereby",⁶ "out of surplus profits",⁷ or "if the purchase is made in good faith and does not prejudice the rights of creditors".⁸ In New York, there is no statutory authority for the acquisition of its own shares by a corporation, and the rule is well settled that a corporation has the power to acquire its own stock provided the purchase is made from funds taken from surplus profits instead of capital.⁹ Some states have elaborate provisions enumerating the situations in which they will permit the purchase of a corporation's own stock and the limitations thereon.¹⁰

A variety of business reasons is advanced for the purchase of its own stock by a corporation. Among the reasons commonly advanced for such purchases are:

(1) To retain an established policy in a corporation. This would be particularly applicable to close corporations¹¹ which classification comprises a sizeable proportion of all corporations in the United States.¹² The purchase of a block of stock in a close corporation by an outsider might create a complete change in policy, management and earning capacity for the corporation. Many years of hard work in developing a close corporation may be jeopardized by the sale of some stock to a stranger whose only interest, for instance, is the payment of dividends. Such sales may often be avoided during the lifetime of the stockholder by purchase of available stock by other stockholders or by the corporation itself. The death of the stockholder also offers the opportunity for an outsider to purchase stock from the estate of the deceased unless adequate precautions are taken

⁶ Michigan Stat. Ann., Sec. 10135-10, c. 195 (1945), requiring showing of cumulative effect of such purchases. Indiana Gen. Corp. Act; Nevada Gen. Corp. Law.

⁷ North Dakota Comp. Gen. Laws, sec. 10-0323. (1943), where unanimous consent of its stockholders may permit purchase out of surplus funds.

⁸ In re Fechheimer Fishel Co., 212 Fed. 357, 129 C. C. A 33 (114).

⁹ City Bank v. Bruce, 17 N. Y. 507 (1858); Richards v. Ernst Wiener Co., 207 N. Y. 59, 100 N. E. 592 (1912); Cross v. Beguelin, 226 App. Div. 349, 235 N. Y. S. 336, affirmed 252 N. Y. 262, 169 N.E. 378 (1929); Sec. 664 of New York Penal Code, as amended by L. 1924, c. 221, declares a director guilty of a misdemeanor who concurs in any vote "to apply any portion of the funds of such corporation, except surplus, directly or indirectly to the purchase of the shares of its own stock."

¹⁰ Arkansas, California, Colorado, Connecticut, Delaware, Florida, Indiana, Louisiana, Maine, Maryland, Michigan, Missouri, New Jersey, North Dakota, Ohio, Oklahoma, Rhode Island, Tennessee, South Dakota.

California's Law, for example, provides that a corporation cannot purchase its own stock contrary to the provisions of the statute on the subject unless it is necessary to save itself from loss, such as taking stock in payment of a loan. Mancini v. Patrizi, 87 Cal. App. 435, 262 Pac. 375 (1927).

¹¹ A close corporation is defined in Words and Phrases, in the popular sense, as meaning a corporation in which stock is held in few hands, or in few families, and which stock is not at all, or only rarely, dealt in by buying or selling. Words and Phrases, p. 498.

¹² Limiting a close corporation to one having not over 10 stockholders, it is estimated that there are 200,000 such corporations in the United States against a total number of corporations of 300,000. Prentice Hall Trust Service, Sec. 8017 (1946).

in advance of such death. One very popular plan in use by such corporations is designed, through a contract with the stockholder, to provide funds to purchase the stockholder's shares. Briefly the mechanics of such plan are that insurance¹³ is procured on the life of the stockholder and a trustee is named as beneficiary of the policies. Ordinarily in a close corporation most of the stockholders are officers or directors, or in some measure actively take part in the business and there is no question that the corporation has an insurable interest in the lives of such officers who are mainly responsible for its success.¹⁴ The corporation has no insurable interest in the lives of stockholders merely through such relationship alone, but ordinarily special services, skill, and knowledge contributed by the stockholders, most of whom are usually employees, in a close corporation, will furnish an insurable interest.¹⁵ It has been held that insurable interests exist in the lives of stockholders in a close corporation inasmuch as there is a threat of outsiders entering the business to the detriment of existing stockholders upon the death of present stockholders.¹⁶

The agreement between corporation and stockholder provides that on the death of the stockholder the proceeds of the policies will be paid to the estate of the deceased by the trustee, and the stock will be transferred to the corporation. To insure the fulfillment of the agreement and the procurement of the stock by the corporation, the desired number of shares to be sold to the corporation is deposited with the trustee with the rights incident to such stock, such as dividends, voting, stock "split-ups", stock dividends, etc., remaining with the shareholder or given to the trustee by power of attorney. The use of a trustee and the deposit of the stock avoids dissension and a change of mind by the parties at a later date. An incidental concern, of considerable importance in the current condition of high taxes, is that as long as the insured retains no incidents of ownership and the premiums are paid by someone other than himself, there will be no estate tax chargeable on the proceeds of these life insurance policies.¹⁷ Such a plan not only provides the corporation with liquid

¹³ In the event that parties are uninsurable, suitable annuity contracts may be worked out, in order to provide the required funds to execute such a plan as here outlined.

¹⁴ *United Sattes v. Supplee-Biddle Hardwer Co.*, 265 U.S. 189, 44 S.Ct. 546 (1924); *Harris v. H. C. Talton Wholesale Grocer Co.*, 11 La. App. 331, 123 So. 480 (1929); *Baker v. Keet Rountree Dry Goods Co.*, 318 Mo. 969, 2 S. W. (2d) 733 (1928); *Murray v. Higgins Co.*; 300 Pa. 341, 150 A. 629 (1930); *Wurzburg v. New York Life Ins. Co.*, 140 Tenn. 59, 203 S. W. 332 (1918); *Lincoln Nat. Life Ins. Co. v. Scales*, 62 F. (2d) 582 (C. C. A. 10, 1933).

¹⁵ *Rahders v. People's Bank*, 113 Minn. 496, 130 N. W. 16 (1911); *Keckley v. Coshocton Glass Co.*, 86 Ohio 213, 99 N. E. 299 (1912).

¹⁶ *Fleming v. Fleming*, 194 Iowa 71, 174 N. W. 946, 180 N. W. 296, 184 N. W. 296 (1921).

¹⁷ *Treas. Reg. 80, art. 25 (1937).*

funds when required, but also permits the deceased shareholder's estate a proper price for the stock as well as the advantage of ready cash to meet the usual high estate taxes, expenses of administration and last illness, and burial expenses. The purchase price to be paid by the corporation can be agreed upon during normal times without the stress of grief and death. A pre-arranged plan of evaluation of the stock interest or a stated price of sale can be arrived at during the deceased's lifetime and subsequent disputes avoided. The validity of such a life insurance trust is established by statute in Wisconsin.¹⁸

(2) A second reason for repurchasing its own stock is the desire of a corporation to retire some owner, there being no outside market for his shares.¹⁹ This problem does not exist in large corporations where stocks are freely traded on the stock exchanges, but is confined to small, close corporations. More harmonious relations can sometimes be obtained by the elimination of an antagonistic stockholder, and in the absence of a ready market for his shares or a sale to one of the other stockholders, purchase of his shares by the corporation is the only answer.

(3) A third business practice involving stock repurchase is that of providing shares for employees of the corporation under agreements that they will be stockholders during their terms of employment.²⁰ Such plans have merit in that they provide labor with an incentive to work well with management for the success of the corporation. A provision to hold stock during the term of employment usually is accompanied by a stipulation that the corporation shall repurchase the shares from the employee at the termination of his employment with the corporation.²¹

(4) A fourth practice involving purchase of its own stock by a corporation is that of compromising claims or debts owed it by its stockholders.²² Certainly this practice is not to be condemned if it is the answer to a corporation realizing something or nothing on the obligations due it, assuming such debts are bonafide.

¹⁸ Wisconsin Statutes, 206.52 (1945).

¹⁹ *Copper Belle Mining Co. v. Costello*, 11 Ariz. 334, 95 Pac. 94 (1908); *Lindsay v. Arlington Co-op Ass'n.*, 186 Mass. 371, 71 N. E. 779 (1904); *Cole v. Cole Realty Co.*, 169 Mich. 347, 135 N. W. 329 (1912); *Gilchrist v. Highfield*, 140 Wis. 476, 123 N. W. 102 (1909).

²⁰ *Iowa Lumber Co. v. Foster*, 49 La. 25, 31 Am. Rep. 140 (1878); *Fremont Carriage Mfg. Co. v. Thomsen*, 65 Neb. 370, 91 N. W. 25 (1902); *Lawson v. Household Finance Corp.*, (Del. Ch.) 147 Atl. 312 (1929); and *In re Tichenor-Grand Co.* 203 Fed. 720. (D. C. N. Y. 1913).

²¹ *Topken, Loring & Schwartz, Inc. v. Schwartz*, 249 N. Y. 206, 163 N.E. 735 (1928); *Joseph v. Raff*, 82 App. Div. 47, 81 N. Y. S. 546, affirmed 176 N. Y. 611, 68 N. E. 1118 (1903); *Lawson v. Household Finance Corp.* 147 Atl. 312 (Del. Ch. 1929).

²² *Coppin v. Greenless Co.* 38 Oh. St. 275 (1882); *Draper v. Blackwell*, 138 Ala. 182, 35 So. 110 (1903); *Morgan v. Lewis*, 46 Oh. St. 1, 17 N. E. 558 (1888).

Despite the fact that worthwhile business need may well justify the corporate act of acquiring its own stock, the corporation does not always use the power for legitimate purposes. In fact the power is peculiarly subject to abuse. Some of the common abuses are:

(1) The sale of treasury stock at prices less than the original par value or issue price.²³ This is usually accomplished through a build-up of a back-log of treasury stock acquired through gifts from promoters of shares taken by them in over-payment for their work. Such watered shares are then sold to the public for what they will bring in order to gain cash for working capital. Restrictions placed on issue of par value stock, and fixing of stated value for no-par stock, are avoided.

(2) The gaining of control by insiders through the acquisition of stock by corporate purchase. Such treasury stock cannot be voted.²⁴ With their own stock still in their control, the insider's position may be changed from a minority voting group to a majority voting group.

(3) Corporate purchase of stock of favored parties, "in the know", when a corporation has not long to live, and the purchase of their shares at inflated figures when no other market exists,²⁵ are further abuses to which this practice is subject.

(4) The avoidance of pre-emptive rights may be accomplished by the device of treasury acquisitions of stock, since it is generally held that shareholders have no pre-emptive rights in treasury stock.²⁶

(5) Trading by a corporation in its own shares may create an artificial market and cause a false picture to be presented to the public as to corporate condition. The operation, "nothing succeeds like success", may keep an innocent public from knowing that the inner circle buying is a "shot in the arm" from the corporation's own funds, driving the stock price upward. This increment in value is due to artificial factors rather than to increased earnings, new business and good potential outlook for the corporation.

Difficulty sometimes arises in the numerous states, like Wisconsin, which have no statutory provisions relative to this subject.²⁷ However, a judicial guide for action was announced for Wisconsin by the clear

²³ Dewing, *Financial Policy of Corporations*, 434; *Lake Superior Iron Co. v. Drexel*, 90 N. Y. 87 (1882).

²⁴ *American Railway Frog Co. v. Haven*, 101 Mass. 398 (1869); *Walsh v. State*, 199 Ala. 123, 74 So. 45 (1917); Delaware Gen. Corp. Act., sec. 19 (1945); West Virginia Code, sec. 18 (1923).

²⁵ *Grasselli Chemical Co. v. Aetna Explosives Co.*, 258 Fed. 66, 68, (D. C. N. Y. 1918).

²⁶ *Borg v. International Silver Co.*, 11 Fed. 2d 143-47 (C. C. A. 21 (1925)).

²⁷ Michigan, Minnesota, Mississippi, Iowa, Kansas, Nebraska, New Hampshire, New Mexico, North Carolina, Oregon, Pennsylvania, South Carolina, Texas, Washington.

language used in *Federal Mortgage Company v. Simes*.²⁸ The court stated:

"In this state a solvent corporation may purchase its own stock if not prohibited by its articles of organization or some statute."

From this language it might be concluded that no difficulties are likely in connection with this problem. Unfortunately *Federal Mortgage Company v. Simes* does not solve all the problems. Troublesome dictum is to be found in the case of *Rasmussen v. Schweizer*,²⁹ where the Court stated that a Wisconsin corporation may buy its own stock:

"as long as its assets are in substantial excess of its liabilities, and that for such purpose its capital stock is not to be considered as a liability."

This language would seem to permit expenditure of assets in the purchase of stock until a point is reached where remaining assets barely exceed liabilities to third parties. This presents an extreme result, and one contrary to the general rule. This dictum seems to conflict with the general policy of Wisconsin as set forth in its statutes,³⁰ which provide strict standards to insure at all times that the rights of the creditors be properly protected, and the capital stock maintained as a cushion.

Every time a dollar's worth of assets is expended for the purchase of capital stock, whether it comes from earned surplus or capital surplus, the creditor's cushion of assets in excess of liabilities to third parties is reduced. If earned surplus is used for dividends no complaint can be made by a creditor, but a creditor does acquire rights from payment of dividends from capital. The statutes require certain formal steps for reduction of capital stock. Yet the rule of the *Schweizer* case seems to permit impairment of capital by indirection, through purchase by the corporation of its own stock and without any regulation or necessary formal steps. Statutes providing definite steps for the reduction of capital are aimed toward the security of the creditors, yet the back door to such security remains open when adequate controls are not placed on stock repurchase.

Federal statutes prohibit a national bank from lending on security of its own shares of stock, or being purchaser thereof, unless to prevent loss upon a debt previously contracted in good faith.³¹ Such statutes are intended to protect depositors, creditors, and shareholders, and to inspire confidence in the public generally. Private corporations present a different situation requiring a more liberal solution than the

²⁸ *Federal Mortgage Company v. Simes*, 210 Wis. 139, 245 N. W. 169 (1933).

²⁹ *Rasmussen v. Schweizer*, 194 Wis. 362, 216 N. W. 481 (1927).

³⁰ Wisconsin Statutes, 180.06 (3), (4); 180.07 (1); 182.08; 182.10; 182.23 (1945).

³¹ U. S. C. A., Title 12, Sec. 83.

case of the bank. No doubt the private corporation has a larger list of legitimate reasons for the purchase of its own stock than does a bank. But the power is clearly subject to abuse, and it seems a mistake to leave its scope in doubt particularly in the presence of such an invitation to abuse as the dictum in the *Schweizer* case. The huge surpluses accumulated during the war, and prospective profits for the next several years, present great opportunity for trading by corporations in their own stock, and the need for guiding legislation to control such practice seems obvious. Clearly absolute prohibition of stock purchases is not the answer, but there does seem to exist a need for a legislative standard of guidance and control. Legislation on the subject should indicate the circumstances and conditions under which stock purchase may be considered lawful and proper, and free from attack by stockholders or creditors. The writer submits the following conditions as proper for consideration in drafting such suggested legislation:

- (1) Stock purchases generally should be confined to legitimate purposes³² and should be in good faith.
- (2) Purchases should be made only from earned surplus, and they should be properly reflected on the company's records and financial statements.
- (3) At least a two-to-one ratio of current assets to liabilities should remain after such acquisitions.
- (4) No more than a fair market value price should be paid by the corporation, and if no market figure is available the price should be set by disinterested appraisers.

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³² See business reasons 1 through 4, *supra*.