1930

Purchase by a Corporation of Its Own Stock

Irving J. Levy

Follow this and additional works at: https://scholarship.law.umn.edu/mlr

Part of the Law Commons

Recommended Citation
https://scholarship.law.umn.edu/mlr/1512

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.
PURCHASE BY A CORPORATION OF ITS OWN STOCK

BY IRVING J. LEVY*

BEFORE considering the decisions of the courts or the rules of the legislatures, it may not be amiss to look at the business situations which motivate the purchase by a corporation of its own shares of stock. It will provide a background which will help when we come to evaluate the existing law,¹ and it will follow the chronological sequence of the real events—the fact situations before the legal determinations which they call forth.

I

Probably the most frequent use for which corporations purchase their own shares is to effect the compromise of internal dissension.² In the small closed corporation, which has so largely supplanted the copartnership as a business organization, differences over policy of management are likely to be disastrous. Because of the lack of a ready market for shares in such companies, and the inadvisability of dissolution, the retirement of one of the factions is most easily brought about by a surrender to the corporation of its shares for a consideration, and the vesting of ownership of the enterprise in the remaining members. The possible

*Member of the New York Bar.


effect on creditors may not be considered by the parties because the smoothing of the ruffled internal affairs occupies their entire attention, and the business is either in a healthy state or it is thought will become so when the undesirable members cease to be troublesome factors. Payment for the shares may be in available or borrowed cash, or in secured or unsecured notes. In rare instances part of the non-liquidated assets of the company are assigned to the retiring shareholder. In all these cases, the situation may involve a unanimity among all shareholders or else the purchase may be effected over the opposition of dissenters, objecting either to the terms of the purchase or to the purchase generally. In the case of a large corporation whose shares are traded on prominent exchanges, dissatisfied members may in most instances sell their shares during a favorable market to other persons, and the practice we are considering will not have to be resorted to for this purpose very often.

Another use to which the purchase has of late been put is in making provision for the holding of stock as an incident of employment. The industrial utility of employee-shareholders has been profusely and favorably commented upon, and the necessary stock is procured by the corporation from willing sellers through purchase. The transfer to the employees is then usually

---

8First Nat'l Bank v. Salem, etc., (C.C. Or. 1889) 39 Fed. 89.
6Lowe v. Pioneer Threshing Co., (C.C. Minn. 1895) 70 Fed. 646.

In some states the approval of the shareholders is necessary. S. D. Rev. Code sec. 8777. If the purchase is made out of capital, the unanimous consent of the stockholders must be obtained in North Dakota and in Oklahoma. N. D. Comp. L. sec. 4531; Okla. Comp. Stat. sec. 5320.


9R. F. Foerster & Else Dictu, Employee Stock Ownership in the United States. Organized labor, however, is opposed to this method of democratizing industry, regarding it as a back-handed method of weakening the collective bargaining power of unions. Amer. Fed. of Labor, Reports of the Executive Council at the 45th Ann. Conv. (1925) 21, 22.

For a discussion of this problem from a legal angle, see Fordham, Some Legal Aspects of Employee Stock Purchase Plans, (1930) 8 N. C. L. Rev. 161.
PURCHASE BY CORPORATION OF ITS OWN STOCK

made with an option in the company to repurchase them upon the termination of employment, because the employee is desired as a shareholder only while he is an employee, and the shares will be wanted for the person who is to supplant the employee when he retires.

Another purpose for which it is desired that a company be able to purchase its own shares is to permit it, in floating stock issues, to entice otherwise reluctant buyers by contracts to repurchase from them if they desire to back out. To give a prospective subscriber the right to return the shares to the corporation before a certain time limit without loss, and thus give him a chance to reconsider his entry on the venture, is a potent sales feature, analogous to the "money refunded if not satisfied" and the "thirty days free trial" terms which attend the sale of other chattels. These sales may be made with varying degrees of publicity. All the stock may be offered on these same terms or only some of it, and without knowledge by all of the existence of this option to resell. Bankers may take a large block with this string attached; an unsuspecting public may take the rest, with no conditions at all, on the strength of the bankers' subscriptions. The knowledge of creditors of these reservations to the subscriptions may or may not exist, but it will be a very significant factor.

Corporations may take some of their outstanding stock back into the treasury to compromise a claim against or a debt owed by a shareholder. In judging this practice, it will be important to consider the legal implications and potential consequences. For instance, "Topken, Loring & Schwartz Inc. v. Schwartz, (1928) 249 N. Y. 206, 163 N. E. 735; Joseph v. Raff, (1903) 82 App. Div. 47, 81 N. Y. S. 546, affd. 176 N. Y. 611, 68 N. E. 1118; Lawson v. Household Finance Corp. (Cal. Ch. 1929) 147 Atl. 312.


Stockholders need not all be given the same right. Wisconsin Lumber Co. v. Green, etc., Tel. Co., (1904) 127 Ia. 350, 101 N. W. 742.
"Conditional subscriptions to the stock of corporations are unusual and often operate to defeat subscribers who become such absolutely and upon the faith that all the stock is equally bound to contribute to the hazards of the enterprise. It misleads creditors and is a fruitful source of litigation and disaster. Tending to the ensnarement of creditors and contrary to a sound public policy, conditional subscriptions to corporate shares ought not to be encouraged." Paducah & M. Ry. Co. v. Parks, (1888) 86 Tenn. 554, 560, 8 S. W. 842, 844. See White Mts. R. R. v. Eastman, (1856) 34 N. H. 124; 37 Yale L. J. 226.

Coppin v. Greenless Co., (1882) 38 Oh. St. 275; Draper v. Black-
to discover whether or not the debt was otherwise uncollectible.  
Whether or not the shares were fully paid will likewise be a significant consideration.

Treasury stock may be acquired through the necessary power in a corporation to forfeit outstanding shares for non-payment of calls or assessments. In the absence of other buyers, the corporation may have to bid in the shares itself, to hold at least until purchasers can be found. The voluntary surrender of stock by shareholders in cases where otherwise forfeiture would be resorted to presents the same basic situation.

Through a gift or bequest a corporation may become the owner of its own shares. And by operation of law, treasury stock may come into existence. Thus a corporation may be sued for the conversion of a certificate of stock and judgment may be rendered against the defendant. If the corporation satisfies the judgment by payment, the title to the shares will vest in it, and the shares will assume the status of treasury stock.

well, (1903) 138 Ala. 182, 35 So. 110; Morgan v. Lewis, (1888) 46 Oh. St. 1, 17 N. E. 558.

Similarly a corporation may have accepted its stock as collateral for a debt and by enforcing its lien treasury stock may have been created. City Bank v. Bruce, (1858) 17 N. Y. 507.

The term "treasury stock" is loosely used to mean all stock which the corporation holds. Accurately used, it describes only such of the company's shares which have been issued and outstanding, and then donated to or purchased by or in some other way reacquired by the corporation. Treasury stock is supposed to be held for retirement or reissue. See Conyngton, Corporate Organization and Management 96 et seq.; Montgomery, Auditing 133; 5 Fletcher, Corporations 5601.

In respect to mining stock, treasury shares have been held to mean "such stock as is set aside for the actual development of the property." State v. Manhattan Verde Co., (1910) 32 Nev. 474, 109 Pac. 442.


In re Denver Hotel Co., (1893) 1 Ch. 495, 62 L. J. Ch. 450; Alling v. Wenzel, (1890) 133 Ill. 264, 24 N. E. 551.


PURCHASE BY CORPORATION OF ITS OWN STOCK

Thus far we have mentioned those purposes for corporations resorting to a purchase of their shares which might be called bona fide. Whether or not we should conclude that they were in the final analysis justifiable socially or legally, at least much might be said in favor of permitting corporations to exercise the power, within certain limits, to attain these ends. But the practice is not confined to these situations. The device is useful and indulged for more questionable purposes.

Treasury stock has been the time-honored device for marketing "low-grade" securities. Though it has ever been the law that original stock may not generally be issued for less than par, no such restriction attends the sale of "fully paid" stock which has returned to the company's treasury; for the interests of creditors and stockholders are presumed to be protected if the stated price is paid for the stock originally. No reliance is supposed to be placed on the amount a company realizes on those shares which subsequently return to it, and consequently such stock may be sold for less than its par value; so that corporation directors very often, upon acquiring property from among their own kin upon organization, or in payment for "services rendered" by irresponsible lawyer's clerks, issue stock to an amount in accordance with the high valuation placed upon the property or the services. Part of the stock is thereafter donated to the company and becomes "non-assessable, full paid, treasury stock." The price at which it can then be sold to the public becomes a matter


In case such treasury stock were originally issued for property at an overvaluation, an innocent purchaser for value could not be held liable by creditors, though a purchaser with knowledge of the overvaluation might be. Enright v. Hecksher, (C.C.A. 2nd cir. 1925) 240 Fed. 863; Alling v. Wenzel, (1890) 133 Ill. 264, 24 N. E. 551; Coleman v. Howe, (1895) 154 Ill. 458, 39 N. E. 725; Berry v. Rood, (1901) 168 Mo. 316, 67 S. W. 644.
for the "honest discretion" of the directors. Thus a share with $100 emblazoned on its face may be disposed of to a gullible public for considerably less because it is treasury stock. Whether or not creditors today rely on the nominal capital of a company, or investors on the dollar sign on the shares, the device has some interesting potentialities—not least among which is its usefulness as the source of a bonus to be offered with other stock.

Another valuable, albeit questionable, use for treasury stock is to perpetuate the control of the enterprise without the expensive requisite of the ownership of a majority of the voting stock. Treasury stock, it is universally held by the cases and the statutes, cannot be voted. By using the corporate funds to purchase some of the outstanding stock and retire it from the voting arena, what was before a minority in the controlling group can be converted into a majority, and their control may thereby be continued indefinitely. Whether or not a majority can be acquired in this way very often, their relative voting strength, at any rate, can be increased. A more roundabout method of accomplishing this same result is to make such purchase through a subsidiary organized for this purpose. The subsidiary directors would vote the parent stock. The parent directors would vote the subsidiary stock and make their nominees the subsidiary directors. The control of the parent company would remain in the existing board of directors.


Cook, Stock and Stockholders, 3d ed., 421; American Railway Frog Co. v. Haven, (1869) 101 Mass. 398; Ex Parte Holmes, (1826) 5 Cow. (N.Y.) 426. Nor may the stock be voted if held in the name of a trustee for the benefit of the corporation. Ex Parte Holmes, (1826) 5 Cow. (N.Y.) 426; or if it is held by the corporation as pledgee. Brester v. Hartley, (1869) 37 Cal. 15.


This seems to have been permitted in New York. In re Buffalo, etc., R. Co., (1896) 37 N. Y. S. 1048; Lazenby v. Int'l Cotton Mills Corp., (1916) 174 App. Div. 906, 160 N. Y. S. 1, modifying referee's report. However, most courts would probably go behind the corporate entity and prevent the use of a subsidiary to evade the rule that corporations may not vote their own stock. O'Connor v. Int'l Silver Co., (1904) 68 N. J. Eq. 67, 59 Atl. 321. This practice would likewise be disallowed in those states where the statutes stipulate that treasury stock may not be voted "directly or indirectly." Tennessee Gen. Corp. Act, 1929 sec. 12-9. See the address of Wm. H. Clark on Certain Aspects and Legal Problems of the Holding Company, (1930) 82 N. Y. L. J. 96.
PURCHASE BY CORPORATION OF ITS OWN STOCK

Purchasing its own shares permits a corporation giving preferences to favored shareholders—permitting them to withdraw their contribution to a venture in which they have lost confidence, 29 or to withdraw at an advantageous price, 30 or when no other customers are available for their shares. In the case of banks and similar institutions where by statute an additional liability over and above the paid-in capital is imposed on members, the purchase allows the favored member to escape unscathed and leaves the remaining shareholders with the entire burden of satisfying creditors. 31

To avoid the preemptive right of shareholders, treasury stock is useful. Since the beginning of the last century it has been the law that new issues of stock must be offered to existing shareholders, pari passu, before the outside public is given a chance to subscribe. 32 The purpose was to protect their ratable control of the enterprise and their rights in undivided surplus. But it is generally held that shareholders have no right of preemption.

29 Crandall v. Lincoln, (1884) 52 Conn. 73, 52 Am. Rep. 560.

"The enforcement of the contract of purchase would result in securing to the shareholders whose stock the corporation purchased a higher price for their shares than could be realized by the remaining stockholders from the assets of the concern... and thus the capital of the concern might be diverted from its legitimate channels and be used for the benefit of recalcitrant or cantankerous members to the detriment of confiding shareholders." McSherry, J. in Maryland Trust Co. v. Mechanics Bank, (1906) 102 Md. 608, 629, 63 Atl. 70.


31 "For a bank to use its funds in the purchase of stock... might also impair or even destroy all security given by law to creditors of the bank. The law provides in effect that not only the bank with all its property shall be liable for its debts, but also that each stockholder in the bank to the amount of his stock, shall also be held liable. But if a bank may purchase in all its stocks, and own it itself, then where would be the security to the creditors...?"


in treasury stock,33 because upon its reissue their original ratable control is not altered; so that by purchasing stock and then reissuing it to sympathetic parties, the management can avoid the sometimes annoying right of preemption.

The purchase of its own shares has lately been used for purposes of stock manipulation, and the practice has been prevalent enough to call forth a warning from the Governors of the New York Stock Exchange.34 By creating a "bull" market through extensive purchases of its own stock, a corporation sets an artificial value on its shares. Purchases made at a price above the intrinsic value of the shares would impair the finances of the company and reduce the intrinsic value of the remaining shares.35 Purchases made at a figure less than the book value though possibly a source of profit, would be mere speculation and an unauthorized corporate activity,36 economically unproductive and basically more vicious than speculation in the securities of other companies.37 Here again we have the possibility of bringing about


35This is illustrated by the balance sheet of the General Food Corporation for December 31, 1929. On the assets side appears an item, "Investment in company's own stock $4,144,518." A reserve is set up "for fluctuation in marketable securities $430,000." The company purchased in the market break of the fall of 1929 60,000 shares of its common stock. At the beginning of 1930 and for several months thereafter the shares were selling around 60. This makes the market value of the treasury stock about $3,600,000 and explains the reserve set up, since the stock purchased is apparently carried at cost which was greater than the present market value. In the annual statement, the company gives this purchase of its stock as the reason for the decline in the ratio of quick assets to liabilities from what it was the previous year.

36See the opinion of Lord Macnaghten in Trevor v. Whitworth, (1887) L. R. 12 A. C. 409.

Even though the purchase was for speculation, it has been held that an injunction would not issue in favor of one who has acquiesced in the practice. Coleman v. Columbia Oil Co., (1856) 51 Pa. St. 74.

37Profits realized from such activity might be confused by investors with income derived from the corporation's usual activities. This was one of the reasons which caused the officials' of the New
PURCHASE BY CORPORATION OF ITS OWN STOCK

the same situations through trading in shares of the parent by subsidiary companies.

The people most likely to be affected adversely by the practice are the creditors of the corporation. Whether out of capital or surplus, the purchase of a single share involves the diminution of the corporation assets, and a corresponding impairment of the creditor's security. A purchase may render the corporation insolvent or intensify existing insolvency. From a creditor's point of view, treasury stock is in no sense an asset out of which to realize payment of his claims—at best it is a potentiality for the realization of assets when and if resold. Most of the arguments advanced against the practice of corporations purchasing their own shares have been made with the dangers to creditors in view. The familiar "trust fund" doctrine against the return of any capital to shareholders grew up to prevent similar practices.

To this end, also, the statutory methods for the reduction of capital stock generally require that the rights of creditors be safeguarded. Thus the extent of the reduction is usually so that it will "not reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities plus the amount of its capital stock as so reduced." The consent of the secretary of state is generally required to see that the law has been followed. Public advertisement is some-

York Stock Exchange to frown on the practice. N. Y. Times, January 10, 1930. Another objection is that such a decrease in the outstanding capital stock reduces the base on which the company can issue debentures in the future.

According to newspaper information, the practice we are discussing is supposed to have been indulged in extensively during the fall of 1929 by many of the newly formed "investment trusts."


It is generally held that there is no inherent or implied power in a corporation to reduce its capital stock. There must be statutory authorization. Seignouret v. Home Ins. Co., (C.C. La. 1885) 24 Fed. 332; Tschumi v. Hills, (1897) 6 Kan. App. 549, 51 Pac. 619.

times prescribed. And in some states in order to protect shareholders, the existing division of control is sought to be preserved by requiring a ratable reduction among all members.\textsuperscript{42}

But by purchasing shares from individual shareholders, a factual reduction in the capital can be effected without resort to the elaborate method the statutes prescribe, and for purposes which perhaps the statute would proscribe.\textsuperscript{43} The capital fund might thereby be impaired; the reduction would in almost every case be of necessity non-ratable;\textsuperscript{44} creditors would, at least for a time, be unaware of the change in capitalization. And whether or not the shares were actually retired at a later time, the capital would be reduced for all practical purposes—for there would be no assurance that the shares would be resold, either because the directors made no effort or because no customers could be procured at a satisfactory price.\textsuperscript{45}

The mere possibility of abuse is not of itself an argument against permitting a practice which may be useful. But in the realm of corporation finance and management, the readiness with which a power may be and is being abused may be a valid reason for its abolition, especially when, as we shall later see, the valid functions it serves may be performed by less volatile agencies. It is not suggested that there is no power in a court of equity to restrain abuses of the practice.\textsuperscript{46} No doubt discerning courts should and will prevent the purchase of a company's own shares when done fraudulently or when it conflicts sharply with well recognized and superior legal interests. But there is an entire lack of agreement as to what is an abuse of the power, and in some jurisdictions equitable relief can be expected only against its grosser and more flagrant manifestations.\textsuperscript{47}


\textsuperscript{43}Trevor v. Whitworth, (1887) L. R. 12 A. C. 409.

\textsuperscript{44}But see Currier v. Lebanon Slate Co., (1875) 56 N. H. 262, Berger v. U. S. Steel Co., (1909) 63 N. J. Eq. 506, 53 Atl. 14; and note 126 infra.

\textsuperscript{45}I Machem, Corporations, sec. 514 et seq.; 1 Morawetz, Private Corporations, 2d ed. sec. 112-113.


\textsuperscript{47}For the sharp split of authority on the merits of the practice and the limitations to be imposed thereon, see, Cook, Corporations,
forced to seek recourse to an equity action to restrain the abuse of a power, conceded to exist, is at best a doubtful and inadequate remedy, and in the case of a small shareholder, the costs and difficulties of prosecuting make it prohibitive.

II

With this sketch of the uses to which the power to purchase its shares is or may be put before us, it is now proposed to examine the cases and statutes.

We find very little case or statute law on corporate problems in this country before the beginning of the last century. Private corporations were not unknown in the colonies, but they were few in number. Cases involving corporations appear in the courts slowly in the early 19th century, and when they do arise they involve for the most part banks and insurance companies with only a sprinkling of industrial corporations. The industrial corporation begins to assume a prominent position in the second half of the century with the rapid expansion of industry generally, and thereafter its growth is phenomenal. General incorporation laws, tax exemptions in various forms, and special privileges from states vying with one another to attract industries to settle within their borders fostered corporate development.

In the early stages of our law, American judges and lawyers got their notions about corporations from English cases and

sec. 312 et seq., Morawetz, Private Corporations, 2d ed., sec. 112-13; Machen, Corporations, sec. 514 et seq., sec. 626.  
49The common law prohibition of corporations except by royal charter was the law in the American colonies as well as in England. 1 Machen, Corporations 2.  
50Davis, Early History of American Corporations 91; Henderson, The Position of Foreign Corporations in American Constitutional Law, pp. 12 ff.;  
51Chancellor Bland of Maryland stated that the only corporations which existed in that province were what we now call public corporations. (1829) 3 Bland's Ch. Dec. (Md.) 416-420. The monopolistic feature characterized early American corporations as it did their English prototypes. Henderson, The Position of Foreign Corporations in American Constitutional Law 16.  
52In Volume I of the U. S. reports covering the years 1790-1806 three per-cent of the total of cases reported involve private corporations; in Vol. 6 (1824-1826) 11 per-cent; in Vol. 102 (1880) 36 per-cent; in Vol. 246 (1917), 57 per-cent. See Carter, The Corporation as a Legal Entity, 26.  
53What was probably the first general law for the formation of business corporations in this country was passed in New York in 1811, New York, Laws 1811, ch. 67. Other early general incorporation laws are, Ohio Laws 1811, ch. 15; Pennsylvania, Laws 1835-1836, ch. 194; North Carolina, Laws, 1836-37, chs. 10-12, 1837, p. 214.
treatises. But the law in England in the early part of the last century relating to business corporations was not very helpful, especially for the solution of the problems presented by the dynamic organization which the corporation of this country was becoming. On the problem of the purchase by a corporation of its own shares, the English cases were confused and confusing until near the close of the century, and were further complicated by a failure to differentiate clearly between principles applicable to joint-stock companies without limited liability of members, and corporations proper. So when our problem comes before the courts for the first time, there is little, if any reliance on English precedent and the judges and lawyers are forced to unravel it on considerations of policy and logic. It is not surprising, therefore, that from an early date there has been a lack of unanimity on the power to make such purchases.

The first case in this country seems to have been one in 1828, in which a Georgia court held that a bank could invest idle capital in the purchase of its own stock which it could thereafter sell. That creditors might be concerned with the transaction was perceived, but the substitution of the stock for the money in the treasury was thought to be without prejudice to them. The court likewise appreciated that such practices might be indulged in by the directors to maintain control, but thought it could not properly inquire into motive. Thus, in the first case, we have the problem squarely raised, its major implications considered and decided in a way destined to become, with certain refinements, the prevailing American view.

---


54 Not until 1844 was there a general corporation law in England which tended to encourage the use of the corporate form. 7 & 8 Vict. ch. 110, and not until The Companies Act of 1862 (25 & 26 Vict. ch. 89) was passed, did English company law enter its modern phase.


56 See Levy, Purchase by an English Company of its Own Shares, (1930) 79 U. of Pa. L. Rev. 45.


58 However, the Georgia legislature soon after disagreed and passed a statute making the purchase of stock a misdemeanor and subjecting president and directors to fine and imprisonment for its violation. Georgia, Penal Code 1850, ch. 9, 6th Div. sec. 43.

59 The court also decided that shareholders had no right of pre-emption in the treasury stock when the directors saw fit to reissue it.

60 In Georgia, it has since been disapproved of. Fitzpatrick v. McGregor, (1909) 133 Ga. 332, 65 S. E. 859. That case also criticized
PURCHASE BY CORPORATION OF ITS OWN STOCK

This case, strangely enough, though a square holding for the power, has not been relied on to any great extent by the later courts which also validated such purchases. Dicta of other cases are quoted and relied on, or else the precedents cited are of decisions which dealt with the acceptance by corporations of their stock in settlement of debts owing to them. These latter cases and sweeping generalizations therein were regimented in subsequent cases in support of purchases made not merely to compromise antecedent debts but for other purposes, to show that the majority view in this country authorized a corporation to buy its own shares generally; and by this—not unusual—development that rule did grow up by accretion to become the prevailing view.

The cases under the majority rule permitting the power in corporations fall into several classes, so far as the reasons given for the result. First, there are the courts which find no express prohibition against the practice in the statutes or charter, and seeing nothing inherently vicious in such purchases, decide that

Robison v. Beall, (1858) 26 Ga. 17 where the power was found to exist in the provision of the charter permitting the company "to have, purchase . . . land, rents, . . . goods, chattels and effects of what kind, nature or quality, whatsoever."

Thus City Bank v. Bruce, (1858) 17 N. Y. 507, 508, which seems to be the basis for the New York rule permitting purchases, was the case of a corporation accepting its shares for an antecedent debt. But the language in the case was strong for granting the power generally. The authority given by the court for that generalization and for its own decision was Taylor v. Miami Exporting Co., (1833) 6 Ohio 83, which was likewise a case of accepting stock for a debt. Commissioners of Johnson County v. Thayer, (1896) 94 U. S. 631, 24 L. Ed. 133, cited the City Bank Case for the broad proposition that a corporation may purchase its own shares, though no antecedent debt was involved and the statement was entirely unnecessary for its decision. Thus fortified by strong language from the highest courts, the later cases indulge in sweeping remarks, so that by 1905 in Burnes v. Burnes, (C.C.A. 8th cir. 1905) 137 Fed. 781, on the basis of the above cases, the court states as settled law that, "in the absence of constitutional or statutory prohibition, corporations have inherent power to buy, to sell and to retire their own stock." See note 2 MINNESOTA LAW REVIEW 459.

Thus City Bank v. Bruce, (1858) 17 N. Y. 507, 508, which seems to be the basis for the New York rule permitting purchases, was the case of a corporation accepting its shares for an antecedent debt. But the language in the case was strong for granting the power generally. The authority given by the court for that generalization and for its own decision was Taylor v. Miami Exporting Co., (1833) 6 Ohio 83, which was likewise a case of accepting stock for a debt. Commissioners of Johnson County v. Thayer, (1896) 94 U. S. 631, 24 L. Ed. 133, cited the City Bank Case for the broad proposition that a corporation may purchase its own shares, though no antecedent debt was involved and the statement was entirely unnecessary for its decision. Thus fortified by strong language from the highest courts, the later cases indulge in sweeping remarks, so that by 1905 in Burnes v. Burnes, (C.C.A. 8th cir. 1905) 137 Fed. 781, on the basis of the above cases, the court states as settled law that, "in the absence of constitutional or statutory prohibition, corporations have inherent power to buy, to sell and to retire their own stock." See note 2 MINNESOTA LAW REVIEW 459.

61Thus City Bank v. Bruce, (1858) 17 N. Y. 507, 508, which seems to be the basis for the New York rule permitting purchases, was the case of a corporation accepting its shares for an antecedent debt. But the language in the case was strong for granting the power generally. The authority given by the court for that generalization and for its own decision was Taylor v. Miami Exporting Co., (1833) 6 Ohio 83, which was likewise a case of accepting stock for a debt. Commissioners of Johnson County v. Thayer, (1896) 94 U. S. 631, 24 L. Ed. 133, cited the City, Bank Case for the broad proposition that a corporation may purchase its own shares, though no antecedent debt was involved and the statement was entirely unnecessary for its decision. Thus fortified by strong language from the highest courts, the later cases indulge in sweeping remarks, so that by 1905 in Burnes v. Burnes, (C.C.A. 8th cir. 1905) 137 Fed. 781, on the basis of the above cases, the court states as settled law that, "in the absence of constitutional or statutory prohibition, corporations have inherent power to buy, to sell and to retire their own stock." See note 2 MINNESOTA LAW REVIEW 459.

62See the able dissent of Timlin, J. in Gilchrist v. Highfield, (1909) 140 Wis. 476, 123 N. W. 102 in which he traces the similar development of the rule in that state by this process. For by 1910 in Wisconsin it is stated that "by a long line of decisions here . . . a corporation . . . may, in general, so long as it acts in good faith . . . purchase its own stock . . ." Atlanta, etc., Ass'n v. Smith, (1909) 141 Wis. 377, 381, 123 N. W. 106, per Marshall J.

Judge Timlin analyzes the cases referred to and shows they are authority for no such generalization, referring either to the exceptional facts involved or to the fact that the statements relied upon were entirely dicta.
the power exists. Then there are others which, though they fail to find an express grant of power to purchase its own shares, think the power is incidental and necessary to accomplish the main objects for which the corporation was formed. Another line of cases finds direct authorization in the usual power given corporations in the statutes or charters to purchase, sell and hold property, both real and personal. It had long since been decided that shares of stock, including its own, were personalty, and the definition was felt to have compelling force.

The power is circumscribed, the courts admit, by the usual safeguards against fraud and breach of the fiduciary relation of the directors and majority shareholders, and in this way other parties are thought to be protected. In the cases where treasury stock is created through the settlement of an antecedent debt or by forfeiture, the necessity to save loss is the ground on which the power is predicated.

Fairly contemporaneously with the development of the majority view permitting a corporation to purchase its own stock, a contrary rule took root prohibiting such practices. Here, too, the reasons given for the result vary. There are those courts which regard a corporation as a legal personality of limited powers,

---


64Thus in Dupee v. Boston Water Power Co., (1873) 114 Mass. 37, it was held that a corporation chartered with the power to purchase and operate water power plants could, when its water power privileges were no longer profitable, lawfully sell its sites and receive its own stock in payment. See also, Williams v. The Savage Mfg. Co., (1851) 3 Md. Ch. Dec. 418; New England Trust Co. v. Abbott, (1894) 162 Mass. 148, 38 N. E. 432.

65This power will be found in the articles of almost every corporation, whatever its nature. It is inserted to provide for the holding of the incidental property which every company must own. Thus, the United Corporation of Delaware, an investment company, has the power to hold and deal in all kinds of real and personal property in all parts of the world, though its main function is to hold the stock of utility corporations.


PURCHASE BY CORPORATION OF ITS OWN STOCK

operating under a state grant, capable of performing only such acts as are expressly authorized by the state.\(^7\) Failing to find any definite grant of power to buy its own stock, either in the statutes or charter, the purchase is held to be invalid.\(^7\) Or else it is decided that the enumeration of the powers which corporations may exercise implies the exclusion of all others, and the purchase is accordingly disallowed.\(^7\) Others find the purchase an impairment of the security of creditors, and the "trust fund" doctrine is thought to compel the denial of any such power.\(^7\) Some jurisdictions, probing into intra-corporate relations see an injury to the small nonassenting shareholders through a readjustment of voting strength.\(^7\) The possibilities of abuse, and the realization that the device is a way of evading the statutory method for a reduction in capital motivate other courts,\(^7\) and a vigorous minority rule developed which follows, with some qualifications, the English law.

But, as in England,\(^7\) exceptions are recognized to be necessary. Thus, even in such jurisdictions, a corporation may take its own stock as security for an antecedent debt;\(^7\) or in compromise of a disputed claim or a hopeless debt;\(^7\) or in case of the insolvency of its debtor;\(^7\) or by way of gift or devise.\(^7\) And the minority

\(^{70}\) Strauss v. Insurance Co., (1855) 5 Oh. St. 59; Cartwright v. Dickinson, (1889) 88 Tenn. 476, 12 S. W. 1030.


\(^{73}\) This is the most usual reason given for prohibiting the purchase. Whaley v. King, (1918) 141 Tenn. 1, 206 S. W. 31; Crandall v. Lincoln, (1884) 52 Conn. 73, 52 Am. Rep. 560; Kom v. Cody Detective Agency, (1913) 76 Wash. 541, 136 Pac. 1155.

\(^{74}\) This possibility was perceived in Hartridge v. Rockwell, (1828) R. M. Charl. (Ga.) 260, but the court thought it could not properly inquire into the motive behind the purchase. Strangely enough, the later cases seldom considered the problem. Some few did, however, Thomas v. Intl Silver Co., (1907) 72 N. J. Eq. 224, 73 Atl. 833; Borg v. Intl Silver Co., (C.C.A. 2nd cir. 1925) 11 F. (2d) 143. But these cases are concerned with settling a limitation on a power conceded to exist. Cf. Percy v. Millandon, (1832) 3 La. 570, 587.


\(^{77}\) Draper v. Blackwell, (1903) 138 Ala. 182, 35 So. 110.

\(^{78}\) State v. Oberlin Bldg. Ass’n, (1879) 35 Oh. St. 258.

\(^{79}\) Bank v. Overman Carr Co., (1899) 17 Ohio C. C. 353.
jurisdictions generally think an exception to the prohibition should be made to permit a company to accept the shares issued to a purchaser with an option to return them if he so elects. Sometimes this situation is attempted to be distinguished from a purchase by the corporation by calling it the failure of a conditional sale, or its rescission. In any case it is generally permitted.

The statutes on the subject have not been very helpful because they are for the most part sketchy and show the same lack of agreement among the states as previously characterized the judicial rules. In a majority, the purchase of shares is permitted generally; but usually with some limitations, as, "if the capital is not impaired thereby," or "out of surplus" or "out of surplus profits." In some it is allowed in effecting the forfeiture of stock or for satisfying antecedent debts and by implication cannot be made for other purposes. Inclusio unius, exclusio alterius. As has been indicated, in some states it is thought that the power in a corporation to purchase and hold personal property is statutory authorization for the purchase of its shares. A few

82Mulford v. Torrey Exploration Co., (1909) 45 Colo. 81, 100 Pac. 596. But see 5 Fletcher, Corporations 965 to the effect that under the minority rule even such contracts would not be permitted.
84Florida, Comp. Gen. Laws sec. 6534; Louisiana Laws 1928 Act. 250, sec. 23; Tennessee, Laws 1929, p. 235, sec. 12-9; South Dakota, Rev. Code sec. 8777 provides that a purchase may be made out of surplus funds but the consent of the shareholders is necessary.
85North Dakota, Comp. Gen. Laws sec. 4531. But its articles may provide otherwise. Likewise if there is unanimous consent of all stockholders, purchases out of capital are permitted. Oklahoma has similar provisions. Oklahoma, Comp. Stat. sec. 5320. Since these limitations are imposed presumably for the benefit of creditors, it is hard to see why unanimous consent of the shareholders should dispense with their operation.
86Idaho, Comp. Stat. sec. 4745; Maine, Rev. Stat. ch. 51, sec. 40; Mass. Gen. Laws 1821, ch. 156, sec. 20, but by judicial decision in that state a corporation has been held to have the power to purchase its shares for "any legitimate purpose." Brown v. Little, (Mass. 1929) 168 N. E. 525; California Civil Code, sec. 343, 344; Philippine Islands, Corp. Act. secs. 44, 45.
88E. g. New Jersey, see supra note 65; Robison v. Beall. (1858) 26 Ga. 17, 28. But see note 60
states, which have in recent years adopted new corporation acts, have elaborate provisions enumerating the situations in which such purchases may be made and the limitations thereon. Only in a very few jurisdictions are there direct statutory prohibitions against the creation of treasury stock through purchase. In quite a number of states there are no statutes dealing with the problem.

Sec. 8623-41 of the Ohio Code, as amended in 1929 permits the purchase of shares of any class:
   (a) When the articles authorize their redemption.
   (b) To collect or compromise a debt, claim or controversy in good faith.
   (c) In any case where the purchase is made out of "the surplus of the aggregate of its assets over the aggregate of its liabilities plus stated capital" by a 2/3 vote of shares or as the articles provide, "but no such purchase shall be made so as to favor any shareholder over any other."
   (d) For resale or allotment to employees, or in contracts by the company to repurchase shares from employees.
   (e) To eliminate fractional shares.
   (f) "For the purpose of resale to shareholders or otherwise when the articles in substance provide that the corporation shall have a right to preemption if and when any shareholder desires, or at the happening of any event, is required to sell his shares or any part thereof."
   (g) From dissenting shareholders entitled to be bought out.

The Louisiana statute is very similar. In addition it stipulates that treasury stock may be sold by directors at a price they may fix "not to be less than the price at which the same were purchased."

Louisiana, Laws 1928, act. 250, sec. 23.

Wyoming, Comp. Stat. sec. 5056; Kentucky, Stat. (Carrol) sec. 554; but the taking of stock to prevent a loss on a debt previously contracted is permitted. The stock so acquired must be disposed of within a year.

National banks are expressly prohibited from purchasing or holding their own shares except where necessary to save loss on debts previously contracted in good faith. Shares so acquired must be sold, at a public sale if necessary, within six months else the bank may be dissolved. 12 U. S. C. A. sec. 83, 1 Mason's Code, tit. 12, sec. 83.

In Germany a corporation may not purchase its own shares, except in furtherance of plans for amortizing shares as provided by the articles. Commerce Code, Art. 226. Where such purchases are effected the reduction must apply to all shares, pari passu. Exch. Cas. Reps. 25, 258. The new 1929 English Companies Act has a provision which by implication forbids the purchase. 19 & 20 Geo. V. ch. 23, sec. 45.

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

In New York from an early day it has been held that a corporation has by implication the power to buy its own shares. See City Bank v. Bruce, (1858) 17 N. Y. 507. Although the doctrine arose through an extension of the holding in that case, which decided only that a corporation could accept its stock in settlement of an antecedent debt, it has been repeatedly affirmed that the power exists generally. Moses v. Soule, (1909) 63 Misc. Rep. 203, 118 N. Y. S. 410, affd. 136 App.
III

In *In re Tichenor-Grand Co.*,92 Judge Learned Hand made the following observations:

“If a corporation has received property into its treasury of the value of its authorized shares, that is no doubt subject to the vicissitudes of the enterprise, which will be represented by public knowledge of its success or of the value of its shares. If, however, it purchases its own shares this affects neither the value93 of the other shares, the success of its enterprises, nor the amount of its apparent share capital. It is merely a method of secret distribution, against the deceit of which its creditors have absolutely no means of protection. The fund which they have the right to rely upon has been surreptitiously taken from them. . . . It is a strange thing, I think, that there have been cases which


However, the Penal Law has limited the power by making it a misdemeanor for directors to apply any but “surplus funds” to the purchase. *New York, Laws 1909, ch. 88, sec. 664-4.*

Prior to *New York Laws 1924, ch. 221*, the restriction was more rigid, confining the source of funds to “surplus profits” and thus presumably excluding purchases from a surplus arising out of appreciation or the modern device of “paid-in surplus.”

Today in New York a promise by a corporation to purchase its own shares is illusory, because there is no certainty that surplus funds will exist when the date for performance arrives. The promise is not good consideration because the act promised may be a crime and it does not create a valid contract. *Topken, Loring & Schwartz, Inc. v. Schwartz, (1928) 249 N. Y. 206, 163 N. E. 735.*

And where a corporation agrees to purchase its own stock and gives a note in payment, the purchase is invalid and the note uncollectible, though the corporation be solvent, if at the time for payment of the note, it has no surplus. *In re Fechheimer-Fischel Co., (C.C.A. 2nd cir. 1914) 212 Fed. 357. Cf. Cross v. Beguelin, (1929) 252 N. Y. 262, 169 N. E. 378. See (1930) 15 Corn. L. Q. 108.*


93In view of what followed, Judge Hand probably did not mean that the market or book value of the stock might not be adversely affected. He seems rather to mean that this is no transaction which could produce anything of value, as would, say the contribution of the corporation’s funds to a purchase of bonds or shares of another company. In the latter case the corporation would be lending capital to prosecute the business of the other company, and the interest would be the return. But, the use of the company’s own funds to purchase its own shares does not produce anything of economic value, even if the shares are later sold at a profit. This is probably the force behind the United States Treasury ruling that neither taxable profit nor deductible loss can arise from transactions by a corporation in its own stock. *Treas. Dept. Reg. 74, art. 66.* This, however, does not intend to deny that a commercial profit or loss can be realized through such transactions. See (1930) 2 Corp. Practice Rev. 7 for a discussion of the taxation aspect of such purchases.
permit the practice, which seems to me to be inevitably mischievous commercially."

In 1828, Judge William Davies of the superior court of Georgia, delivering his first opinion on the bench and deciding the first case involving the purchase by a corporation of its own stock, made these comments:

"If from the course of the business, or the state of things, the capital of the bank cannot be usefully employed in loans, there can, I think, be no objection against the purchase of its own stock. In such purchases a part of the capital stock is withdrawn, but it is represented by the stock purchased. . . ." It becomes a "part of the capital stock . . . to which the creditors of the bank must look for payment of their claims."

Judge Hand decided that a corporation could not make such purchases of its own stock if no surplus existed; Judge Davies held that such purchases were legitimate corporate activities even though the capital of the company was used. Both appreciated the risks to which creditors were exposed. And in all the cases, it is the apparent conflict between the exercise of this power and the rights of creditors which chiefly concerns the court.

One of the deep-seated principles of our law is the so-called "trust fund" doctrine enunciated by Judge Story in 1824. Whatever criticism has since been levelled against the use of that phrase to explain the legal limitations on the use of the capital of a corporation, the principle remains that it may not be returned to subscribers or shareholders so as to injure creditors. It may

---

95 In the Tichenor-Grand Case, there was a sale of stock to the plaintiff who became an employee, with an option in the vendee to leave at the end of three years and sell the stock back to the company at par. His claim after the bankruptcy of the corporation was disallowed by Judge Hand.
be that today people, dealing with and extending credit to corporations, do not rely principally on the stated capital of the organization, but rather on its current ratio and its prospects of future

Generally there are statutory provisions relating to the sources out of which dividends may be paid. The usual restrictions are that no dividends may be paid if the company would be rendered insolvent; or if the capital would be impaired, but only if made out of profits, or surplus, or surplus profits, or if the remaining assets will be greater than a certain sum. See, e.g., North Carolina, Cons. Stat. Ann. 1919 sec. 1179; Pennsylvania, Laws 1919 p. 914, sec. 8; Missouri, Laws 1921 p. 662; New York Stock Corp. Law sec. 58. The interpretation of these statutes has been a troublesome problem engaging the attention of courts, lawyers and accountants. See Weiner, Theory of Anglo-American Dividend Law, (1929) 29 Col. L. Rev. 461; Reiter, Dividends, Profits and the Law; Palmer, Company Law, 12th ed., 226 et seq.; Sparger, Surplus and the Payment of Dividends, (1930) 8 N. C. L. Rev. 14; Levy, Purchase by an English Company of Its Own Shares, (1930) 79 U. of Pa. L. Rev. 45, 63.

It should be observed that the problem is basically the same as that of applying the statutes which similarly restrict the funds which a company may use to buy its own shares. And the same considerations should govern the non-statutory restrictions imposed on both transactions. For if the return of capital in the form of dividends is prohibited, certainly the return of a shareholder's entire contribution to the venture should not be allowed even though his shares are received in return. This limitation on the power to purchase is imposed even in the absence of statute. Hamor v. Taylor-Rice Eng. Co., (C.C. Del. 1897) 84 Fed. 392; Tiger v. Rogers Cotton Cleaner Co., (1910) 96 Ark. 1, 130 S. W. 585; Buck v. Ross, (1896) 68 Conn. 29, 35 Atl. 763; In re S. P. Smith Lumber Co., (D.C. Tex. 1904) 132 Fed. 618.


To authorize a purchase of shares out of paid-in surplus is almost as objectionable as though it were made out of capital; for both funds represent the contributions of the subscribers to the venture, and to permit the withdrawal of either injures creditors and remaining shareholders both. See Corliss v. United States, (C.C.A. 8th cir. 1925) 7 F. (2d) 455, 456; Pierce v. United States, (1920) 255 U. S. 398, 41, Sup. Ct. 365, 65 L. Ed. 697.

But see the able opinion of Judge Mitchell in Hospes v. Northwestern Mfg. & Car Co., (1892) 48 Minn. 174, 50 N. W. 1117, which, though critical of the use of the phrase "trust fund" to describe the legal limitations on the use of capital, points out how on the whole the same results are reached on the theory of fraud or holding-out. Creditors are presumed to deal and extend credit in reliance on the representation made by corporations through their stated capitalization
earnings. But the protection afforded by the law which attempts to keep the capital fund intact against dissipation is not incon-
siderable. The ultimate test comes when there is insolvency. In such situations the property and assets which represent the capital contribution of the shareholders are the sources from which will be realized whatever the creditors will get. The current ratio, the prospects of earnings, if relied upon, have proved delusive. But the purchase of some of its shares by the corporation will have depleted this capital fund by a return to some shareholders of that which would have been available for creditors when their day of reckoning came, in the same way as an outright gift to shareholders of some capital or a cancellation of unpaid subscriptions would deplete that fund. The latter are dearly prohibited, yet they are no more objectionable so far as creditors are concerned than the former practice. It is true that the capital stock purchased is returned to the treasury, as the Georgia court pointed out, and may be looked to by "creditors . . . for payment of their claims." But it is hardly necessary to point out the utter worthlessness to creditors of the shares of an insolvent corporation.

And so it is that generally, either by statute or judicial rule, the power is limited to purchases which are "out of surplus," and, if not as represented, creditors are defrauded. Ballantine, Corporations 673 et seq.


101"If a corporation be incompetent to release subscribers to its capital stock whose subscriptions have not been paid, it is equally without authority to expend the fund represented by the capital stock to purchase shares held by a stockholder who has paid for them." McSherry, C. J. in Maryland Trust Co. v. Nat'l Mechanics Bank, (1906) 102 Md. 608, 626, 63 Atl. 70. See the opinion of Lord Herschell in Trevor v. Whitworth, (1887) 12 A. C. 409.

The objection to such purchases is that "they necessarily result in keeping up the appearance of a capital which has actually been depleted." Learned Hand, J. in Re Tichenor-Grand Co., (D.C.N.Y. 1913) 203 Fed. 720, 721.


105For illustrations of the statutes, see supra note 84; Grasselli Chemical Co. v. Aetna Explosives Co., (D.C.N.Y. 1918) 258 Fed. 66; Western & Southern Fire Insurance Co. v. Murphy, (1916) 55 Okla. 702,
or "which do not impair the capital," or which do not reduce the assets of the corporation "to an amount less than its debts and liabilities."  But in some states it seems to be enough if the purchase does not bring about outright insolvency, and for such purposes the capital stock of the corporation is not reckoned as a liability. In others, the only expressed limitation on the power is that it be not exercised "to defraud creditors." The well-known difficulty of proving fraud will suggest itself to indicate how entirely inadequate is this protection afforded to creditors. The supposed inviolability of the capital fund in our jurisprudence will show the anachronism of the power to make the purchase out of capital.

IV

The principal objection to the practice under consideration is not its effect on creditors—the legislatures and courts have perceived the dangers in this direction and to an extent provided therefor—but its effect on the intra-corporate relation among shareholders. Strangely enough, this possibility of abuse by a management of the power to create treasury stock has seldom been perceived either in this country or in England where the power is firmly denied. And yet it is this aspect of the device which seems especially vicious.

Whatever injustice there may be in the "divorce of suffrage and control from ownership" in modern corporations, which engaged the ire of Professor Ripley, at least in situations where a person buys stock which he knows to be without voting power he has exercised his choice with the facts before him. That is to say, if a person buys shares in a company in which he knows the control is centered in a small block of stock owned by a clique of which he is no part, he buys into such a situation with his eyes open. Whether or not the law should, in spite of this, impose

156 Pac. 885; ("surplus profits" held to mean surplus of any kind.)
111 Berle, Studies in the Law of Corporation Finance 163; Ballantine, Corporations 144 et seq.
112 Main Street and Wall Street.
the exacting duties of a trustee on the owners of the management stock\textsuperscript{113} is a nice question of ethics on which there is a very respectable difference of opinion.\textsuperscript{114} But suppose he buys into a situation in which he knows that $100,000 has been dedicated to the enterprise; that he is to have three-tenths of the voting power because he has contributed $30,000 to the venture for which he has received three-tenths of the total stock, all of which has voting rights. He assumes that control of the policies of the corporation will be in the owners of shares representing at least $50,000 of invested capital. Should we permit a group representing $40,000 of invested capital, but temporarily in control of the directorate, to use the company to create $21,000 of non-voting treasury stock, convert their minority interest into a majority power, and thereby perpetuate their control?\textsuperscript{215} If creditors were not permitted to object, either because the surplus funds were used or no insolvency resulted, the transaction would seem to be unimpeachable under the rule in many jurisdictions. It may well be that a discerning court would set such a move aside.\textsuperscript{116}


\textsuperscript{115}Even the requisite majority of shareholders cannot amend the articles of incorporation to strip a block of stock of voting power. Lord v. Equitable Life Assurance Soc., (1909) 194 N. Y. 212, 87 N. E. 443. "... the scheme of corporate management is that of a representative government, in which the representatives are bound to be governed by and represent only the interests of those they represent. Hence any device or practice which in any wise or to any degree diminishes or prevents the exercise of the right of each of the active owners to have a voice in the election of directors precisely in the proportion to the amount of his interest is vicious and in positive contravention of the fundamental principle upon which our corporations are built up." Pitney V. C., in O'Connor v. Int'l Silver Co., (1904) 68 N. J. Eq. 67, 68, 59 Atl. 321.

\textsuperscript{116}A critical court would probably prevent such a purchase when it was a deliberate move to gain control in the face of a pending contest between factions. Elliot v. Baker, (1907) 194 Mass. 518, 80 N. E. 450; Luther v. Luther Co., (1903) 118 Wisc. 112, 94 N. W. 69; O'Connor v. Int'l Silver Co., (1904) 68 N. J. Eq. 67, 59 Atl. 321.

However, these were strong cases and the courts indicate that they will probably intervene only when no other end but the gain of control motivates the purchase, and the voting power is being rearranged with a contest in view. Short of such flagrant abuse of the practice by the directors for which there is equitable relief, there still remain possibilities for considerable redistribution of control. Every such rearrange-
but if the "legal" method were followed, it would be a difficult job to show fraud or overreaching, especially if the court were disinclined, as was the Georgia court, to examine into motive.\textsuperscript{117}

The shareholder in our suppositious case can hardly be said to have bought into such a situation. True it is that he could have foreseen that a majority of the shares might come into the hands of a single individual or an unsympathetic group. But this would be through the usual transfer of shares among individuals. He did not anticipate that the company's funds would be diverted from their normal ends of prosecuting the business of the enterprise to rearrange the control or serve the personal interests of the management.\textsuperscript{118}

And even if the instances in which a purchase would change a minority interest into a controlling interest would be rare, the purchase of a single share rearranges the corporate structure and changes the proportionate control of every member.\textsuperscript{119} The status of our shareholder is altered, and factually the venture on which he originally agreed to embark is not the same.\textsuperscript{120}

\begin{itemize}
  \item Hartridge v. Rockwell, (1828) R.M. Charlty. (Ga.) 260.
  \item Grasselli Chemical Co. v. Aetna Explosives Co., (D.C.N.Y. 1918) 258 Fed. 66, 68.
  \item It may be that today when so much stock offered to the public has no voting power and the interest of the small shareholder in exercising his vote when he has one seems slight, this question loses much of its practical importance. However, when a real contest for control arises within the managing group, votes become vastly important even if all classes of stock do not have them. Witness the rise in the value of the shares of the Standard Oil Co. of Indiana during the fight in 1929 by John D. Rockefeller, Jr., to oust Col. Stewart from control.
  \item And in the small corporation, the proportionate voting strength will ever be a vital feature of the ownership of its stock.
  \item Where cumulative voting is provided for by reducing the number of voting shares through a purchase by the company, the minority shareholder may raise his proportionate interest sufficiently to enable him to elect himself to the board of directors. See Drinker, The Preemptive Right of Shareholders to Subscribe to New Shares. (1930) 43 Harv. L. Rev. 586, 603.
  \item The purchase by a corporation of its own stock not only changes the fractional interest of the dissenting shareholders against his will but it changes the character of his property in which he has
\end{itemize}
In another significant sense the acquisition of treasury stock changes the enterprise. The contributed capital is intended for carrying on the business of the company. The amount of capitalization may be important in inducing people to invest in the venture. A man may be quite willing to invest $5,000 in a corporation which is to start in the business of manufacturing with $1,000,000 original capital, and yet be quite unwilling to risk his money in a company which will have only half that sum to go along in a highly competitive field. When a company purchases its shares out of capital, it retires from its treasury a sum which was originally contributed for the prosecution of its business and may leave available for that purpose a smaller sum than that on which some shareholders might have originally insisted before entering the company.  

For the majority rule, it may be argued that by this "reduction" of outstanding stock the remaining shareholders stand a chance of getting an increased dividend, as treasury stock is not counted as outstanding stock entitled to share in profits. The answer is that their share of possible losses is also increased. And further, though certain claims upon future dividends are extinguished by creating treasury stock through purchases, at the same time a corresponding quota of working capital is destroyed. With a decreasing working capital the profits of the business will most probably be smaller and the pro rata share of the remaining shareholders will not be enhanced by the transaction. In fact, our supposed shareholder will feel that his profits will be cut down for when he invested his money he thought the exigencies of the venture required the full amount of the original capitalization. And the management is here altering the original interest, deprives him of the chance of dividends, increases against his will his proportionate liability to clerks and servants and laborers . . . and also is effectual in silencing and eliminating a shareholder (the seller to the corporation) who might rate with dissenting stockholders at the next corporate election and against the office-holding majority." Timlin, J., dissenting in Gilchrist v. Highfield, (1909) 140 Wis. 476, 482, 123 N. W. 102.

This is the force behind the rule that in the absence of legislative authority the capital stock of a corporation may not be reduced. Droitwich Patent Salt Co. v. Curzon, (1867) L. R. 3 Exch. 35; Cartwright v. Dickinson, (1889) 88 Tenn. 476, 12 S. W. 1030; Star Publishing Co. v. Ball, (1922) 192 Ind. 158, 134 N. E. 285. And wherever it has been appreciated that a purchase is, for a time at least, an indirect reduction of capital—in those jurisdictions courts have refused to imply any power in corporations to make such purchases. Trevor v. Whitworth, (1887) 12 A. C. 409; Abeles v. Cochran, (1879) 22 Kan. 405, 31 Am. Rep. 194; Crandall v. Lincoln, (1884) 52 Conn. 73, 52 Am. Rep. 560.
corporate structure on which the subscriber might be presumed to have relied when he entered the venture.

Nor is the situation greatly improved when the purchase is made out of surplus, so far as objecting shareholders are concerned. Money is invested in shares of stock as in most other things for the realization of profits in the form of dividends. A considerable amount of discretion is vested by laws in the directors in deciding in what instances profits shall be paid out to the shareholders as dividends. For it may be good business policy to build up a reserve or surplus account for a variety of reasons. But it is hardly anticipated by those who buy shares that profits will be diverted to permit some few members to retire their capital contribution and share of the surplus from the venture, thereby postponing the payment of dividends to the others. If the shares are purchased at a price above the actual value of the shares, the remaining members' share in the undivided surplus is impaired, and money is actually being taken from the pockets of the remaining members for the benefit of the retiring shareholders. If the purchase is made at a price commensurate with the actual value of the shares, the surplus which would ordinarily be devoted to dividends is instead tied up to effect either an indirect and unauthorized reduction in capital or else the possibility of dividends is postponed until such time as the treasury stock can be and is resold at an adequate price. The price at which it is then reissued will again affect the share of the undivided surplus which each member had before, and it is not rash to suppose that all these transactions can hardly be effected without that share in the surplus being in some way altered. Lastly, if the surplus is used to buy shares for a price less than their intrinsic value and a profit is realized when they are later reissued at a higher price, even then the distribution of the surplus as dividends has been postponed, and the additional profit is realized from a "trafficking in its own shares." This is no proper


\[123\] Such a transaction could probably be enjoined if the overvaluation was flagrant enough to be indicative of fraud. But even within the limits of honest discretion by the directors, the value of the remaining shares might be appreciably affected. See the illustration from the balance sheet of the General Food Corporation, supra note 35.

\[124\] People who buy such shares on the market relying on the company's earnings are likely to be misled into believing that the
PURCHASE BY CORPORATION OF ITS OWN STOCK

“object” of any corporation for the prosecution of which a charter could be obtained in any state, and it seems hardly a justification for withholding dividends from investors. And yet, in every jurisdiction where purchases are permitted at all, these results may be brought about. The directors, moreover, decide whose shares are to be bought, and are thus permitted to declare who is to get his contribution and part of surplus forthwith, and who must continue with his share of the surplus withheld.

V

Let us now consider the practice from a theoretical point of view. As was pointed out by the House of Lords in the leading English case of Trevor v. Whitworth, a purchase of its own shares by a corporation will be either of two things. It will be in effect a reduction in the capital stock, or else it will be a “trafficking in shares.” That is to say, either the shares will be purchased for retirement to reduce the capital stock of the corporation or they will be for a time dormant as treasury stock to be later reissued.

Almost every state has a statute which prescribes a method for bringing about a reduction of capital stock. Some require that the elaborate procedure of amending the charter be followed. In many at least the sanction of a stockholders’ meeting is neces-

profits were realized from the primary activity of the company and that they were indicative of a healthy state of affairs.

Grasselli Chemical Co. v. Aetna Explosives Co., (D.C. N.Y. 1918) 258 Fed. 66. This assumes a case where all the shareholders were willing to sell their shares at that price. Obviously the company could not buy all.

In all these cases, it is to be observed, the relative status of the remaining shareholders in the venture will almost always be disturbed, because the purchases will almost always be non-ratable. The rule requiring a ratable treatment of shareholders when a reduction of capital is proposed, General Investment Co. v. American Hide and Leather Co., (1925) 98 N. J. Eq. 326, 129 Atl. 244, does not apply to a purchase though the same reasons for a like rule exist. Shoemaker v. Washburn Lumber Co., (1897) 97 Wis. 585, 73 N. W. 333. In Berger v. U. S. Steel Co., (1902) 63 N. J. Eq. 809, 53 Atl. 68, the court said that companies desiring to purchase their own stock must offer to buy from all equally. This, however, cannot be the rule for it would render the device nugatory in all the transactions in which it is usually used. Thus it would be useless for buying out a faction for then the offer would have to be extended to all, and if there was general acceptance the corporation would disappear. At any rate, the Berger Case is not the law even in New Jersey for the statutes authorize a non-ratable purchase. New Jersey, Comp. Stat. sec. 29.

(1887) 12 A. C. 409.

See note 41 supra.

Massachusetts, Gen. Laws, 1921, ch. 156, sec. 45; New York Stock Corp. Law secs. 37, 38; Colorado, Comp. Laws, sec. 2276-2283.
The filing of a certificate and the approval of some state official is a usual prerequisite. Sufficient assets must be left to safeguard creditors. In this way the state has sought to preserve the rights of creditors and shareholders from a decrease in the capital of a company. But the same states in many cases permit the purchase of its shares with no such stringent restrictions. And yet a reduction in capital may thus be brought about as effectively as though the statutory mode were followed. For even though the shares are not retired and are carried on the books as treasury stock, for all practical purposes the stock is not outstanding and is as though it had been reduced. Only


It is sometimes provided that dissenting shareholders may in the event of a reduction of capital have their shares appraised and paid for by the corporation. Indiana, Ann. Stat., Burns, 1926, sec. 4958. See the Uniform Bus. Corp. Act. sec. 42-1. These statutes recognize the injury which a reduction in capital may cause an objecting member.

Thus Massachusetts requires that to reduce the capital stock the articles must be amended—an elaborate proceeding calling for a stockholders’ meeting, the approval of the secretary of state, etc. Massachusetts Gen. Laws 1921, ch. 156 sec. 46. Yet the directors may purchase shares of its stock with the company's funds. In the absence of fraud or insolvency the transaction will be unimpeachable. Elliot v. Baker, (1907) 194 Mass. 518, 80 N. E. 450. Since nothing prevents the directors from keeping the stock in the treasury indefinitely, a reduction of stock can thus be as effectively brought about as though the statutory mode were followed.

In North Dakota a stockholders’ meeting must be called, two-thirds of the outstanding stock must approve, and a certificate of the reduction filed with the state. North Dakota, Comp. Law sec. 4557, as amended by North Dakota Laws 1921, ch. 46. Yet its statutes also provide that a corporation may purchase its own shares, and here again it is not necessary to resort to the statutory method if a reduction is sought. North Dakota Comp. Laws sec. 4531.

In New York the certificate must be amended, the proposed change advertised and the state's consent obtained. New York Stock Corp. Law. secs. 37-38. But treasury stock can be created in much simpler style—by purchasing shares out of surplus.

Florida and Delaware are more consistent. One of the ways of reducing capital under their statutes is through the purchase of shares. Florida Comp. Laws, 1925, sec. 22; Delaware, Gen. Corp. Law sec. 28.

Machens regards a purchase by a company of its own stock as “a subtle method of evading the rule against unauthorized reduction of capital.” Modern Law of Corporations, 514.

Morawetz in his well-known treatise says:

“No verbiage can disguise the fact that a purchase by a company of shares in itself really amounts to a reduction of the company's assets.” Private Corporations, 2nd ed., 113.

It does make a difference for purposes of taxation. See Knickerbocker Importation Co. v. State Board of Assessors, (1907) 74 N. J. L. 583, 65 Atl. 913.

Thus it is is not included in computing dividends; West Vir-
PURCHASE BY CORPORATION OF ITS OWN STOCK

a few states make it mandatory that the shares be resold. In the others there is no such compulsion. And even in the former, it is hard to see how the reissue can be compelled—for there is no assurance that at a future date there will be customers "ready, able, and willing" to buy at what the directors may deem a fair price.

The statutes, in laying down in detail the procedure for reducing the capital or for the redemption of preferred stock, certainly intended that to be the sole method. Those provisions of necessity must be exclusive, else they lose all their force. And

Virginia Code, ch. 53, sec. 18; nor for purposes of a quorum, Florida Comp. Laws 1925, sec. 8; nor can it be voted, Delaware, Gen. Corp. Law sec. 19; Ex Parte Holmes, (1826) 5 Cow. (N.Y.) 426; it is not properly speaking an asset of the corporation, Borg v. Int'l Silver Co., (C.C.A. 2nd cir. 1925) 11 F. (2d) 143; Stevens v. Olus Mfg. Co., (1911) 74 Misc. Rep. 508, 130 N. Y. S. 22; Cf. Coit v. Freed, (1897) 15 Utah 426, 49 Pac. 533. It is not in any true sense an outstanding obligation of the company. Borg v. Int'l Silver Co., (C. C. A. 2nd cir. 1925) 11 F. (2d) 143. Of course, treasury stock does offer the opportunity to realize assets in the future when the stock is sold.

And yet, in Vermont unless treasury stock is disposed of within five years, the corporation may be dissolved. Vermont, Gen. Laws sec. 4920. Within that period, the trustees, in whose name the corporation's shares must be held, are to try to dispose of them without loss, but in "any event" they must sell them before the five years elapse. This offers some interesting opportunities for chicanery. The provision seems to be of questionable worth.

Lord Herschell in Trevor v. Whitworth, (1887) 12 A. C. 409, said:
"... the stringent precautions to prevent the reduction of the capital of a limited company, without due notice and judicial sanction, would be idle if the company might purchase its own shares wholesale and so effect the desired result."

In this country no judicial order is necessary to reduce the capital, but the states have provided administrative substitutes for the judicial supervision which the English law prescribes.

And yet, even where a statute forbade the company to "divide, withdraw, or in any way pay to the stockholders or any of them any part of the capital... or reduce its capital stock except as authorized by law," with a proviso allowing the company to accept its own shares in settlement of bad or doubtful debts, a federal judge held that the company, if at the time insolvent, might with the assent of all its shareholders purchase a majority of its shares, though it involved the use of its capital. In re Castle Braid Co., (D.C. N.Y. 1906) 145 Fed. 224. In a recent Montana case, a subscriber sued a corporation on its promise to repurchase its shares. The defense was that it was financially unable to do so. Specific performance was decreed, because the court said that even though insolvency existed, there was no showing that any creditor or stockholder would be injured. "Where the reason for the rule fails the rule fails... we see no reason why the plaintiffs are not entitled to judgment, even if the corporation is insolvent." Davies v. Montana Auto Finance Corp., (1930) 86 Mont. 500, 284 Pac. 267. However these cases seem clearly wrong and would probably not be followed.
yet, by permitting a purchase at the same time, the states provide an alternative method which may well prove useful when some shady practice is contemplated and some part of the statutory procedure would prove embarrassing; for it is a far cry from the elaborate procedure of amending the charter or calling a stockholders' meeting to a mere resolution of the directors which is sufficient to bring treasury stock into existence.

But let us assume that the purchase is not to circumvent the statutes in effecting a reduction of capital, but is made to create treasury stock which is later to be reissued. And let us assume that customers can then be secured to bring about a fair resale. This leaves us with the principle that corporations may "traffic in their own shares." Now it is clear that no state would permit a corporation to come into juristic being for the sole purpose of trading in its own shares. Corporations are allowed only for socially useful purposes. No economist would contend that such a company was performing any useful function since its funds would be used to buy its own shares which are thereafter to be sold and then bought again. This would be sheer speculation, and it would not long subsist even for this purpose, for the practice lacks any foundation to cause a variance in the price. By the same token, this object, clearly illegal and anti-social if alone, would seem to be no more valid when combined with corporate objects which are legitimate. It is as economically unproductive in combination as it is alone, and has the same speculative elements.

It seems therefore that a purchase of its own shares by a corporation is unjustifiable theoretically from either view—either because it is an indirect reduction of capital in evasion of the statutory method or because it is a "trafficking in its shares." The English courts have recognized this dilemma and have disallowed the practice.\footnote{From the standpoint of metaphysics, it is difficult to conceive of a corporation—a legal personality—being a member of itself. This logical difficulty troubled Lord Watson in Trevor v. Whitworth, (1887) 12 A. C. 409. And if a corporation purchased all of its shares (which it might theoretically do in some states if it had no debts), we should have a case of a corporation dissolving itself into nothingness by the device of swallowing its viscera and leaving, perhaps a surplus of assets in vacuo without an owner. The practice offers considerable food for fantastic speculation.}

It may be urged that no Procrustean bed of logic forces us to choose between these two theoretical explanations of the practice. That is, it may be argued that the purchase is no reduction
because there is no permanent retirement of the shares,\textsuperscript{144} for the
shares may be reissued and the assets replenished; and also that
it is not necessarily a “trafficking in shares,” for such purchases are
indulged in (when made honestly) not for purposes of profit nor
as an object of the venture, but as an ancillary and necessary measure\textsuperscript{144} to effect the results we have indicated at the beginning
of this article—to settle intra-corporate dissensions, as the machin-
ery for employee-shareholder plans, etc.

It will therefore be profitable to consider whether this means
is indispensable for attaining these legitimate ends.

\textbf{To Settle Internal Dissension}

Settling intra-corporate disputes by buying out a vigorously
objecting minority is not always an unmixed blessing. Dissenting
shareholders who make things unpleasant for the group in control
often act as efficient deterrents against dubious practices and they
are not always to be discouraged.

Lord Macnaghten once asked:

"Who are the shareholders whose continuance in a company
the company or its executives consider undesirable? Why, share-
holders who quarrel with the policy of the board, and wish to
turn the directors out; shareholders who ask questions which it
may not be convenient to answer; shareholders who want informa-
tion which the directors think it prudent to withhold. Can it
be contended that when the policy of directors is assailed, they
may spend the capital of the company in keeping themselves in
power, or in purchasing the retirement of inquisitive and trouble-
some critics?"\textsuperscript{145}

He and the other Law Lords thought not, and disallowed the
purchase.

But suppose it is agreed that it will be better for the company's
well-being to rid itself of undesirable shareholders and that they
are willing to sell their shares. Should the majority be permitted
to use the corporate funds to bring this about? Certainly not if
creditors will thereby be injured. Nor should the majority be
allowed to do it against any dissent\textsuperscript{146}—for the non-assenting mem-

\textsuperscript{145} Borg v. International Silver Co., (C.C.A. 2nd cir. 1925) 11 F.
(2d) 143.

\textsuperscript{144} American Railway Frog Co. v. Haven, (1869) 101 Mass. 398.
\textsuperscript{146} Trevor v. Whitworth, (1887) 12 A. C. 409.
\textsuperscript{147} Thus under common law the unanimous consent of the stock-
holders was necessary for the sale of all the assets of a solvent cor-
poration; Abbot v. American Hard Rubber Co., (1861) 33 Barb. (N.Y.)
578; or to effect a consolidation or merger, Geddes v. Anaconda Min-
ing Co., (1920) 254 U. S. 590, 41 Sup. Ct. 209, 65 L. Ed. 425; or to
change the nature of the business, Natusch v. Irving, (1824) 2 Coop.
ber ought to be able to insist that the enterprise continue with its capital structure unaltered, except when the articles are amended. And where there is no dissent by the remaining members the retirement of the troublesome members can be brought about by reducing the capital. If the majority are loath to follow the statutory mode of reduction because it is perhaps too slow or arduous, it is not unjust to compel them to purchase the shares as individuals to gain the unopposed control they seek. This would be requiring an additional contribution to the venture to keep it as it was when the state first sanctioned it. The history of corporations in our "liberal incorporation states" should warn us against providing wide powers for directors to play fast and loose with.147

It is to be remembered that the dissension can only be obviated by a purchase of shares where the dissenters are willing to sell. If the shares have a ready market they may and should be disposed of there. Buying out opposition at a premium above the market price should not be encouraged because of its effect on creditors. So far as the interests of shareholders who object to the purchase go, it should be prohibited for it will dilute their share of the assets.148 In a small corporation, therefore, where the shares have no ready market and the necessity to look elsewhere for purchasers exists, two available methods of getting rid of troublesome factions have been suggested. The power in the corporation to purchase its own shares is not essential.

EMPLOYEE-STOCKHOLDER PLANS

Though it is supposed to be industrially desirable149 that employees have a proprietary interest in the business for which they are working,150 this argument would have to yield when it con-temp. Cott. 358; or in the financial structure, Kent v. Quicksilver Mining Co., (1879) 78 N. Y. 159.

147 See Ripley, Main Street and Wall Street.

148 Similarly in cases where shareholders are not consulted and they are at least "non-assenting." This will be the usual situation for the directors themselves can usually make the purchase.

Such a purchase might be enjoined by a shareholder if the disparity between the value of the shares and what was paid was considerable. DuPont v. DuPont, (D.C. Del 1917) 242 Fed. 98.

149 But see 33 Am. Federationist 1191; note 9 supra.

150 It is here suggested that if under these schemes the employee is given the same class of shares which the general public generally gets for its money, the proprietary interest and control which he acquires is negligible. Stripped of voting power his position approaches the status of a creditor.
PURCHASE BY CORPORATION OF ITS OWN STOCK

flicted with more fundamental interests. Thus it could not be permitted to reduce the company to insolvency, or to deplete the capital of the company. In other cases, the needed shares for incoming employees can be procured from authorized but unissued stock, or by increasing the capital stock. If the policy of the company is to have the employee cease to be a shareholder when his employment ceases, the sale to him of the stock can be with an option in the remaining shareholders or in some of them to repurchase. These latter can then resell those same shares to the new employees who will replace the old. This option would not create an illegal restraint on alienation and is generally enforceable.


This is the plan which the Illinois and New York statutes, supra note 151 formulate.

A subsidiary organized for the purpose of carrying through these employee-shareholder plans, if kept strictly to that activity, would seem to offer a feasible solution of the problem. The Illinois and New York statutes provide for it.


At any rate it is no more objectionable than a similar option in the corporation to repurchase under the existing schemes. Bloomingdale v. Bloomingdale, (1919) 107 Misc. Rep. 646, 177 N. Y. S. 873.

Further, in the case of a corporation a general promise to repurchase its employees' shares may be invalid because of some legal restrictions on the funds which the company may devote to the purchase. Williams v. Brownstein, (D.C. Me. 1924) 1 F. (2d) 470; Topken, Loeb & Schwartz, Inc. v. Schwartz, (1928) 249 N. Y. 206, 163 N. E. 735; Cf. Chapman v. Ironclad Rheostat Co., (1898) 62 N. J. L. 497, 41 Atl. 690. This would be true even in the case of preferred stock. Koeppler v. Crocker Chair Co., (Wis. 1929) 228 N. W. 130. And of course these restraints may invalidate the agreement made with the employees. No such troubles would attend options in individual shareholders to repurchase when the employee quit, or in a subsidiary organized for that purpose.
If this suggested method for employee-shareholder plans is too cumbersome, the purchase of its shares might be permitted by statute for this purpose without conceding the power generally.

**IN STOCK-SELLING SCHEMES**

From a social standpoint, it is of questionable value to permit corporations to sell their stock with the right in the vendee to resell to the company if dissatisfied. A share of stock is different from an ordinary chattel, and a sale of stock with an option to return it presents a different situation from a similar right attached to the sale of common merchandise. Certainly creditors, if unaware of such reservations to the subscription, might protest against the exercise of this option when the venture has become a bad one, for the subscriber will then want his money back and will seize upon the right to return the shares. The creditor will be looking to the capital of the failing enterprise for the satisfaction of his claim. To permit the shareholder to exercise his power in such a case is to prefer him to a creditor, or at least to convert him into a creditor. To call this practice a rescission of a sale or the failure of a conditional sale may be a legalistic differentiation, but it does not alter the fact that the conditional shareholder is being given a preference.

Furthermore, consider the position of other shareholders who have subscribed with no such reservation. If they are unaware at the time they subscribe of the conditions to the subscriptions of others, the deceit is apparent. For the difference between entering a venture in which all the capital has been unconditionally

---

157 See note 13 supra.
162For it is hard to visualize the issue of all the stock of a corporation with similar strings attached. If that were the case, all the subscribers could return their stock and the corporation would fade into nothingness. Such an issue would never be permitted for every state requires a minimum of paid-in capital—e.g., Ohio Gen. Code sec. 8637-37; Missouri, Rev. Stat. sec. 10152. The feature we are discussing will usually be found in subsequent stock issues.
PURCHASE BY CORPORATION OF ITS OWN STOCK

contributed, and one in which there are some capricious subscriptions is great.

The Supreme Court has questioned the desirability of these stock-selling schemes and has cast doubt on their legality.164 Certainly this end is no sufficient justification for granting the broad power to corporations to create treasury stock.

FORFEITURE, SURRENDER, ETC.

Even in England where the prohibition against a corporation purchasing its own shares is well settled, exceptions are recognized.165 Thus, it is appreciated that a company must have the power to forfeit shares for non-payment of calls or assessments.166 This is necessary to lend effective sanction to the organization’s legitimate needs for further contributions, and to enforce subscribers’ promises. No objection is apparent. Neither creditors nor the remaining shareholders can be heard to complain, for either additional capital will be realized when the subscriber yields to the threat of forfeiture or else when the forfeited shares are resold. And even if the shares forfeited remain in the treasury forever or are retired, the obligations of the company are thereby decreased and the other members’ share in the assets is pro tanto increased. And although treasury stock is thereby created, forfeiture is no purchase of its own shares, for it involves no outlay of its company’s assets. There can be no valid objection to this necessary power.

Similarly a surrender of shares in a situation where otherwise the corporation would resort to forfeiture creates treasury stock, but is a harmless transaction.167 But a surrender of shares to a company which called for any monetary outlay by it is as objectionable as, if it could be distinguished from, an outright pur-

164Burke v. Smith, (1872) 16 Wall. (U.S.) 390, 21 L. Ed. 361.

165Trevor v. Whitworth, (1887) 12 A. C. 409.

166It is to be noted that in some jurisdictions even the power to forfeit shares for non-payment of calls is denied in the absence of a statutory grant. Cartwright v. Dickinson, (1889) 88 Tenn. 476, 12 S. W. 1030; Budd v. Multnomah St. Ry. Co., (1887) 15 Or. 413, 15 Pac. 649; Vasey v. New Export Coal Co., (1921) 89 W. Va. 491, 109 S. E. 619. But even though a purchase be prohibited the right to forfeit shares in such situations is generally conceded. Mitchell v. Blue Star Mining Co., (1917) 98 Wash. 191, 167 Pac. 130; Lemoore Canal & Irrigation Co. v. McKenna, (1912) 163 Cal. 736, 127 Pac. 345. Sometimes it is provided that such shares must be sold at public sale and only in the absence of other bidders may the defaulting shares be purchased by the company. Idaho, Comp. Stat. 1919, sec. 4745; Cal. Civil Code 1915, sec. 343.

167Rellerby v. Rowland, (1902) 2 Ch. 14, 71 L. J. Ch. Div. 541; Crandall v. Lincoln, (1884) 52 Conn. 73, 52, Am. Rep. 560; State v. Oberlin Building Ass’n, (1879) 35 Ohio St. 258.
Likewise, if a surrender were accepted in a situation where the shares were not fully paid up and the balance due was collectible, creditors and shareholders alike could object that this was in effect a modified purchase, and that the cancellation of an enforceable claim against the subscriber was parting with valuable corporate assets.

Gifts or bequests of its fully paid shares to a corporation would seem to be unobjectionable and are generally allowed. And where by operation of law, treasury stock is created, of course the law cannot at the same time object to its existence for other reasons.

---


It has been held that a release of unpaid subscriptions is valid against subsequent creditors. Shoemaker v. Washburn Lumber Co., (1897) 97 Wis. 585, 73 N. W. 333. But the relation between creditors and shareholders in Wisconsin is unusual, and the rights of the former with respect to the capital fund are peculiarly meagre there. See Atlanta & Walworth B. & C. Ass'n v. Smith, (1910) 141 Wis. 377, 381, 123 N. W. 106.


172The redemption of preferred stock, though analogous to a purchase of the company's own shares, is, strictly speaking, a species of authorized reduction of capital. Ohio, Gen. Code, sec. 8623-39. Since provision is made as to the details of redemption either in the statutes, Maryland, Ann. Code, Bagby, sec. 50, or in the articles, creditors have notice, and if the statutory mode is followed they cannot complain. Westerfield-Bonte Co. v. Burnett, (1917) 176 Ky. 188, 195, S. W. 477; Mannington v. Hocking Valley Ry. Co., (C.C. Ohio 1910) 183 Fed. 133.


Another situation in which it is justifiable for a corporation to become the owner of its own shares is in the settlement of an otherwise uncollectible debt from one of its shareholders. The justification is the necessity of saving loss.\textsuperscript{173} Likewise in compromising a claim of the corporation against one of its members, the merits of which are in dispute, the directors should be permitted to accept shares.\textsuperscript{174} Here, too, the device would be resorted to in order to save the corporation money and trouble.\textsuperscript{175}

Of course, the limitation on the exercise of the power in these cases is that the directors use honest and reasonable judgment that the debt is otherwise uncollectible or that the disputed claim merits this sort of compromise.

In those states where provision is made for buying out dissenters in the event of certain radical corporate changes,\textsuperscript{176} such as mergers or consolidations, the purchase of its shares either for retirement or resale would have to be allowed. This right to payment will have to be restricted, however, so that the necessary protection to which creditors are entitled will not be jeopardized.\textsuperscript{177} Thus, in those states where this possible conflict is perceived it is provided that dissenters shall be paid only if sufficient surplus funds are available, or if enough assets would remain to satisfy

Fed. 647. Thus a provision in a stock certificate by which the corporation binds itself to redeem the preferred stock at a fixed date confers no absolute right to redemption on the holder and will be enforced only if the rights of creditors are not prejudiced thereby. Koeppler v. Crocker Chair Co., (Wis. 1929) 228 N. W. 130. Warren v. Queen & Co., (1913) 240 Pa. 154, 87 Atl. 595. Quaere whether such a promise gives rise to any contract at all. Topken, Loring & Schwartz Co. v. Schwartz, (1928) 249 N. Y. 206, 163 N. E. 735.


\textsuperscript{174}State v. Oberlin Building Ass'n, (1879) 35 Oh. St. 258.

\textsuperscript{175}It is probably desirable that the corporation have the power to eliminate fractional shares by purchase. The Ohio Corporation Act was amended in 1929 to provide for this. Ohio Code, sec. 8623-41.

\textsuperscript{176}See for example, Massachusetts, Gen. Laws ch. 156, sec. 46; New York Stock Corp. Law, secs. 21, 87, 38, 14, 105; Kentucky, Ann. Stat. (Carrol) sec. 558.

\textsuperscript{177}Thus payment to dissenters should not be permitted if it would render the company insolvent, or make it otherwise unable to meet its obligations. And where the statutes or decisions permit purchases of its own stock only out of the corporation's surplus, this limitation will most probably have to be carried over to restrict this remedy of dissenters. An alternative solution is to decide that since there are not enough surplus funds to care for dissenters, the corporation cannot go ahead with the change which brings about the need for buying out dissenters. See Levy, Rights of Dissenters to Appraisal and Payment, (1930) 15 Corn. L. J. 420.
the corporation's obligations. This conflict of interests is a large problem involving the reconciliation of the right of creditors, majority shareholders and investors.

**Conclusions**

The problem seems to the writer to be essentially this. Should the state concede to corporations this power to purchase their shares generally and leave it to courts of equity to restrain its abuse? Or should the power be denied because it is theoretically unsound and practically capable of wide and flagrant misuse; and further because the useful functions it serves can be performed by other well-recognized corporate devices? It will have been gathered that the writer leans strongly to the latter view. The history of corporate practices in our "liberal incorporation states" should show us the dangers attending the grant of wide powers and the inadequacy of the equity actions to keep them within proper bounds.

And the problem must be met. Too much of the nation's wealth is tied up in the shares of corporations and in the debts they owe to permit us to deal lightly with the situation. To leave the matter in the discretionary powers of a court of equity for solution is not enough. At best it provides an injured shareholder with a weak weapon in a struggle where the odds are against him. The suit is slow and costly, and the full records are not easily accessible. Moreover, our courts have displayed a reluctance to interfere in business management or to disturb the effect of the contractual agreements involved in corporate relations. The problem calls for statutory regulation. And this has been appreciated in a great many states, although the regulation has seldom been sufficiently comprehensive. But though the problem seems to have been appreciated in many states, it seems to the writer that

---


179 The estimated wealth of the United States has been set at between 350 and 500 billion dollars; its industrial wealth at between 150 and 250 billion dollars; The estimated net assets of all corporations at 140-150 billion dollars and the gross assets of 200 "largest corporations" (1927) at $68,450,000,000. The figures are from Berle, Materials in the Law of Corporation Finance 171, based on Moody's Manuals for 1928.

180 See the dissenting opinion of Learned Hand, J., in Barclay v. Wabash Ry. Co., (C.C.A. 2nd cir. 1929) 30 F. (2d) 260 which was adopted by the Supreme Court in (1930) 280 U. S. 197, 50 Sup. Ct. 106.
the solution has been faulty. That the denial of the power to purchase its own shares entails no great hardships in financing corporations, and prevents numerous undesirable corporate practices, this paper has sought to show; also that such a rule would make of our corporation law a more consistent science. That its practice would be productive of no dire consequences, the history of corporations in England in the last half century is ample testimony.\textsuperscript{181}

\textsuperscript{181}Since this paper was first written, the board of governors of the New York Stock Exchange have acted and prohibited investment companies which are listed on its board from purchasing their own shares either directly or through subsidiaries. See the New York Times for May 27, 1930. These corporations are reported to have engaged in the practice of trading in their own shares on an extensive scale. During the market break in the fall of 1929, these purchases at high prices resulted in large losses when the shares subsequently receded in value. Because of the complicated and pyramided financial structure of most of the large investment \textquotedblleft trusts\textquotedblright, it is difficult to learn with any definiteness the extent and results of these activities; but the action of the Exchange indicates that the practice must have been widespread and the consequences bad.

The ruling of the Exchange does make allowances for \textquotedblleft exceptional circumstances\textquotedblright when purchases will be permitted under surveillance of the governors. What these circumstances are is not specified in the formal ruling, but it is believed that they cover those situations where a company must accept its own shares to save loss—e.g. for antecedent debts otherwise uncollectible or to enforce calls. These are the usual exceptions made in those jurisdictions where purchases are generally prohibited.

It is difficult to understand why the Exchange has limited its ruling to investment corporations. The purchase of its shares by a corporation whose main activity is manufacture or transportation or what not has the same consequences as the acquisition of treasury stock by a company which is in the business to buy, hold and sell the stock of other corporations. If the Exchange appreciates that the dangers attending the trafficking in their own shares by corporations call for a prohibition, it should make it cover all corporations. The London Stock Exchange has done this. To do otherwise is to provide a half-way remedy based on an arbitrary classification.