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### POWER OF A CORPORATION TO REPURCHASE ITS STOCK

There is reason to believe that the Montana cases,<sup>1</sup> in adopting the common law limitations on the power of a corporation to purchase its own stock, ignore the implications of the relevant statute. The common law rule, in the form approved by the cases, is "that a private corporation may purchase its own stock if the transaction is fair and in good faith; if the corporation is not insolvent, or in the process of dissolution; and if the rights of its creditors are in no way affected thereby."

The provision of the statute,<sup>2</sup> however, is that "the directors of corporations must not make dividends, except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock; nor must they reduce or increase the capital stock, except as hereinafter specially provided . . ."

It is apparent that the term "capital stock" is used in this statute with two different meanings;<sup>3</sup> it is first used as meaning a fund of assets equivalent to the total "liability" on all outstanding<sup>4</sup> stock (*i.e.*, par value or, if no par, valuation entered in the Capital Stock Account), but in its second use the meaning is that the total stock liability cannot be decreased nor the authorized capitalization increased. But do the cases adopt these meanings?

Some Courts have construed such statutes strictly. Thus, the California Court, interpreting a statute<sup>5</sup> identical with that

<sup>1</sup>Porter v. Plymouth Gold Min. Co., 29 Mont. 347, 74 Pac. 938, 101 Am. St. Rep. 569 (1904); Davies v. Montana Auto Finance Corp., 86 Mont. 500, 284 Pac. 267 (1930).

<sup>2</sup>FLETCHER, CYCLOPEDIA OF LAW OF PRIVATE CORPORATIONS, Secs. 1136, 1141, so states the common law rule, adding however, "if without prejudice to the rights of other stockholders." BALLANTINE ON PRIVATE CORPORATIONS, Sec. 66, says that by the "general" rule a corporation can purchase its own stock provided only that it have a "surplus." He cites both statutory and non-statutory cases. *Cf.* STEVENS ON CORPORATIONS, Sec. 60, p. 247. He limits a similar rule strictly to power of corporation under repurchase subscription contracts—quite a different question. *Cf.* GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE, Sec. 88. Does Ballantine assume that the word "insolvent" in the general rule is defined so as to require a surplus? That capital stock sometimes is described as a liability, though not generally considered a correct accounting practice, see Weiner, THEORY OF ANGLO-AMERICAN DIVIDEND LAW, 29, 461, 465 (1929); Cannon v. Wiscassett Mills Co., 195 N. C. 119, 141 S. E. 344 (1928); Borg v. International Silver Co., 11 F. (2d) 147, 150 (C. C. A., 2d, 1925).

<sup>3</sup>R. C. M., 1935, Sec. 5939.

<sup>4</sup>See GRAHAM AND KATZ, *supra*, note 2, Sec. 83; BALLANTINE, *supra*, note 2, Secs. 128-129.

<sup>5</sup>This must be understood as including treasury stock although, strictly speaking, there is no "liability" on such stock.

<sup>6</sup>CAL. CIV. CODE, 1929, Sec. 309 (en. 1872).

of Montana, declared the expression "capital stock" to mean "not the shares of which the nominal capital is composed, but the actual capital—*i. e.* assets—with which the corporation carries on its corporate business." Since, of course, all assets are used to carry on the business, this limitation might mean almost anything. In fact, later California cases have construed "capital stock" to mean all of the assets of the corporation, thus absolutely prohibiting general purchases by a corporation of its own stock.<sup>8</sup>

The Utah Supreme Court achieved a similar result in construing a statute<sup>9</sup> like that of Montana except for the use of the word "capital" instead of "capital stock". It held that "capital" meant "assets".<sup>10</sup> The Utah Court said in effect that, while the statute might be construed to allow buying of a corporation's own stock out of the "earned surplus", since the corporation can so easily "pad" its surplus account and thus avoid the spirit of the statute, the corporation will not be allowed to buy back its stock under any circumstances.<sup>11</sup>

Other jurisdictions likewise construe this or a similar statute either so as absolutely to prohibit a corporation from buying its own stock or at least to limit greatly that power.<sup>12</sup>

On the other hand, the extreme view that there is no impairment of capital so long as the repurchased stock remains in the treasury has been expressed by the Colorado Court.<sup>13</sup>

<sup>8</sup>*Shulte v. Boulevard Gardens Land Co.*, 164 Cal. 464, 129 Pac. 582, 583, 44 L. R. A. (N. S.) 156 (1913). The Court found a surplus and enforced the stock sale and repurchase contract. However, it is submitted that had this not been a sale and repurchase contract, exception would not have been made even though a surplus were found.

<sup>9</sup>*Hansen v. California Bank*, 17 Cal. App. 2d 80, 61 P. (2d) 794, 801 (1936); *Stevens v. Boyes Hot Springs Co.* 113 Cal. App. 479, 298 Pac. 508, 510 (1931).

<sup>10</sup>R. S., Utah, 1933, Sec. 103-12-4, sub. 2.

<sup>11</sup>*Pace v. Pace Bros. Co.*, 91 Utah 132, 59 P. (2d) 1, esp. on rehearing, 91 Utah 149, 63 P. (2d) 590 (1936).

<sup>12</sup>The reasoning, that a contrary rule necessarily would permit creation of an artificial surplus through markup of assets in boom years, is clearly unsound, as shown by the cases disallowing such practices for dividend purposes. *Kingston v. Home Life Ins. Co.* 11 Del. Ch. 258, 101 Atl. 898 (1917); *Southern California Home Builders v. Young*, 45 Cal. App. 679, 188 Pac. 586 (1920).

<sup>13</sup>In *Kom v. Cody Detective Agency, Inc.*, 76 Wash. 540, 136 P. 1155 (1913), the Washington Court's interpretation of the statute (REM. AND BAL. WASH. STAT., Sec. 3697; see also, REM. REV. STAT. OF WASH., 1932, Sec. 3823) absolutely prohibits the repurchase by a corporation of its own stock. Maryland reads this prohibition into the statutory provisions for reduction of stated capital. *Maryland Trust Co. v. National Mechanic's Bank*, 102 Md. 608, 63 Atl. 70 (1906). See *In re International Radiator Co.*, 10 Del. Ch. 358, 92 At. 255, 256 (1914), "a corporation may use only its surplus for the purchase of shares of its own capital stock . . . ;" followed in *Ashman v. Miller*, 101 F. (2d) 85, 90 (1939).

<sup>14</sup>*Colorado Industrial Loan and Investment Co. v. Clem*, 82 Colo. 399, 260 Pac. 1019, 1022 (1927).

The statute,<sup>14</sup> although expressly authorizing a corporation to purchase its own stock, forbade use of funds for this purpose "when such use will cause an impairment of capital." The Court stated that "if the directors merged or extinguished or cancelled the stock after its purchase" impairment of the capital of the corporation "might be the result . . . but there is no evidence at all here that anything of that sort occurred, and the record justifies the assertion that the Company holds this stock in its treasury and may, at any time it sees fit and could do so, sell the same . . . It is presumed to be held as an asset of the corporation for sale."<sup>15</sup>

Prof. Ballantine has condemned the "unfortunate practice" approved by the Colorado case, commenting that "no asset is received to take the place of what is paid out, any more than in the case of a dividend. Earned surplus may not be reimbursed by carrying treasury shares as an asset."<sup>16</sup>

The latter view was adopted by the Delaware Court under a similar statute.<sup>17</sup> The Court said that capital impairment as here used "means the reduction of the amount of the assets of the company below the amount represented by the aggregate outstanding shares of the capital stock of the company. . . . The statute must mean, therefore, that the funds and property of the company shall not be used for the purchase of shares of its own capital stock when the value of its assets is less than the aggregate amount of all the shares of its capital stock."<sup>18</sup>

There are only two Montana cases<sup>19</sup> on this problem.<sup>20</sup> In

<sup>14</sup>COLO LAWS, 1921, Sec. 2260.

<sup>15</sup>Such views may be partly explained by the fact that courts are misled by accounting practices. The purchase by a corporation of its own shares is sometimes recorded as an asset. Judge Learned Hand's opinion in *Borg v. International Silver Co.*, *supra*, note 2, may be cited as not disapproving this practice; but what he really meant was that as an *accounting device* it makes little difference how recorded so long as the proper corresponding entries are made on each side of the ledger. See GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE, Section 89, esp. p. 165, stating that "it is considered better practice to omit treasury stock from the asset side." Regardless of how the treasury shares are shown on the balance sheet the "stated surplus" will be misleading unless their share value is expressly charged against the surplus. GRAHAM AND KATZ, *loc. cit.*

<sup>16</sup>*A Critical Survey of the Illinois' Business Corporation Act*, 1 U. OF CHI. L. REV. 357, 366 (1934). See in accord, GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE, Section 89; MORAWETZ ON PRIVATE CORPORATIONS, Section 112.

<sup>17</sup>Section 19 of the General Corporation Act of Delaware (REV. CODE, 1938, Sec. 2051).

<sup>18</sup>In *re International Radiator Co.*, *supra*, note 12; *Ashman v. Miller*, *supra*, note 12.

<sup>19</sup>Cited *supra*, note 1. *Barth v. Pock*, 51 Mont. 418, 155 Pac. 282, 285 (1915), though discussing the general doctrine of the Porter case involved only a *gift* to a *banking* corporation of its own stock, hence is not considered.

<sup>20</sup>This paper makes no attempt to evaluate directly these two Montana

the first case,<sup>21</sup> where the corporation had sold the stock and agreed to repurchase it, the Court, while denying relief because the plaintiff had failed to tender the stock, went on to uphold the latter agreement with no reference to the statute<sup>22</sup> except the final clause quoted therefrom, which prohibits reduction of capital stock except as otherwise provided by statute. It was said that the corporation was not shown to be insolvent, but no definition of insolvency was given. The Court held that there was no unlawful reduction of capital stock, saying: "The mere repurchase of this stock would not tend to decrease the capital stock of the company . . . The company could own and deal with it just the same as it had done before the sale. . . . When it is transferred to the company, it becomes a part of its property. It is there for the creditors and stockholders. The capital stock is not decreased. A portion of the capital of the company may be unavailable until the stock is again sold and issued, but nothing is destroyed . . . ."

The above language suggests that the Montana Court, like that of Colorado, failed to realize that the share certificates, while in the corporate treasury, are not and do not represent property. It cannot be denied that a purchase by a corporation of shares of itself is a reduction of assets.<sup>23</sup> As the Utah Court said, in considering the Montana view, "it would give little comfort to a creditor if he found all the assets gone but the treasury full of the corporation's own stock certificates, paid for by its assets."<sup>24</sup>

The issue was more squarely presented in a later case<sup>25</sup> which also involved a sale and repurchase contract. After reciting the common law limitation, the Montana Court interpreted insolvency as an "insufficiency of assets to pay its debts in full" (*i. e.*, debts as distinguished from obligations to stockholders). The Court recognized that the corporation was insolvent but said "there is no showing in the complaints that there are any creditors of the defendant corporation, nor that

cases as precedent on the general power of a Montana corporation to repurchase its own stock. Though they have been cited and severely criticized in other jurisdictions as stating the Montana rule, they may be distinguished and limited on several grounds. The failure of these cases fully to consider R. C. M., Sec. 5939, and the *assumption* that the question is governed solely by the common law rule in Montana, is the concern of this comment.

<sup>21</sup>Porter v. Plymouth Gold Min. Co., *supra*, note 1.

<sup>22</sup>*Supra*, note 3.

<sup>23</sup>See GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE, Section 89; MORAWETZ ON PRIVATE CORPORATIONS, Section 112. Of course it is true that a mere repurchase does not amount to a technical cancellation of stock, so as to require a reduction in the capital stock account. In fact, capital stock reduction in this manner is uniformly prohibited. Cf. GRAHAM AND KATZ, *supra*, Section 83.

<sup>24</sup>Pace v. Pace Bros. Co., *supra*, note 10.

<sup>25</sup>Davies v. Montana Auto Finance Corp., *supra*, note 1.

the enforcement of plaintiff's demands will work any injury to any stockholder." The Court enforced the agreement. The statute was not mentioned.

This examination of cases reveals that, in applying statutes like this, a large majority of Courts have, on one ground or another, prohibited corporations from purchasing their own stock or have limited such purchases to surplus.<sup>26</sup> Since the only two Montana cases raising the question at all did not involve the *general* power to purchase, and since the Court considered the pertinent sections of the statute not at all, it is submitted that the Montana Court is free to announce whatever rule a thorough examination of the question justifies. In stating that rule, however, the Court should bear in mind two points: (1) The *minimum* requirement of the statute standing alone is that the corporation in any event have assets in excess of the capital stock account valuation of the outstanding shares and that it be limited in its purchases to that excess of assets; (2) The common law rule regulating such purchases has not been repealed by the Montana statute, but rather supplements it. It would be well, also, to hearken to the words of a leading authority,<sup>27</sup> that the governing rule should be particularized to fit each type of stock transaction. California has so formulated its law by statute.<sup>28</sup> Perhaps that is the most satisfactory way of handling the question.

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<sup>26</sup>*Supra*, notes 2 and 12. Cf. *Pace v. Pace Bros. Co.*, *supra*, note 10; GRAHAM AND KATZ, *op. cit.*, Sec. 88. The last-cited writers say, "The result of this view [the trust fund doctrine] is that the purchase of a corporation's own stock may be made only "out of surplus," i.e., only if the net assets after the purchase are at least equal to the amount of the stated capital." This is supposed to be a statement of the prevailing rule "apart from statute." But is "surplus" used in the accounting sense here? In any case the meaning of the statement is problematical. Though probably more satisfactory than any other inclusive rule, it is difficult to support the position either that such statute or the so-called trust fund doctrine alone *compels* the rule that the corporation must have a surplus in the strict accounting sense before it buys its own stock. Suppose a corporation has \$10,000 capital stock outstanding, \$15,000 assets, and \$25,000 debts. The statute of itself protects only a fund equivalent to \$10,000. Thus the corporation would be allowed to purchase \$5,000 worth of its own stock, though there clearly is no surplus. But the common law *plus* the statute may impose much more extensive limitations.

<sup>27</sup>STEVENS, *op. cit.*, p. 240.

<sup>28</sup>CAL. CIV. CODE, 1933, Secs. 342, 342-a.