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Corporations -- Agreement to Repurchase Own Stock

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Professor Coates is on leave this fall in connection with his Institute of Government. Mr. J. H. Chadbourn has completed his study of Lynching and the Law and is now devoting his full time to the School as an assistant professor in charge of the courses in Legal Ethics, Civil Procedure One, Evidence and Federal Procedure, and as faculty editor of the NORTH CAROLINA LAW REVIEW. He is the first graduate of the School to hold the latter position.

Visiting professors in the summer session of 1932 included James M. Landis of Harvard, Henry Rottschaefer of Minnesota, Bryant Smith of Texas and Dean Julian S. Waterman of Arkansas. The attendance the first term was normal but there was a decrease in the registration for the second term. All of the students certified by the School successfully passed the State Bar examination held in August.

Professor Breckenridge spent the summer in Washington, engaged in research for the Interstate Commerce Committee of the House of Representatives. Dean Van Hecke taught the subject of Contracts in the summer session of the Law School of Northwestern University.

During the last school year the Law School prepared nine research reports at the request and for the use of the Constitutional Revision Commission.

NOTES AND COMMENTS

Corporations—Agreement to Repurchase Own Stock.

A Virginia corporation, through its chief executive officer, sold shares of its stock to plaintiff with a written agreement to repurchase the stock at the same price at any time the owner desired to sell. In an action for breach of the contract to repurchase, it was held that, since the corporation had power to purchase its own stock, it was liable to the extent of the full purchase price.¹

Authorities are divided as to the inherent power of a corporation to purchase its own shares. The English and minority American view is that, in the absence of statutory authority, a corporation has no power to purchase its own shares.² The theory is that such pur-

²Trevor v. Whitworth, 12 App. Cas. 409 (1887); In re London, H. & C. Exch. Bank, 5 Ch. App. 444 (1870); Cartwright v. Dickenson, 88 Tenn. 479, 12 S. W. 1030 (1890); Hall & Farley v. Ala. Terminal & Improvement Co., 143 Ala. 464, 39 So. 285 (1905); Wilson v. Torchin Lace & Mercantile Co., 167 Mo. App. 385, 149 S. W. 1156 (1912); Bear Creek Lumber Co. v. Second Nat.
chase is *ultra vires*, because it is an unauthorized trafficking in the shares, or an illegal reduction of the capital stock.\(^3\) A substantial American majority, including North Carolina,\(^4\) holds that such a power, in the absence of statutory or charter restrictions, is not *ultra vires*, and that it may be exercised where there is no fraud or prejudice to the rights of creditors.\(^5\) These courts generally hold that the purchase must be made from surplus funds and not from capital stock funds.\(^6\) Some states have statutes prohibiting the purchase by a corporation of its own stock.\(^7\) Other states expressly

Bank of Cumberland, 120 Md. 566, 87 Atl. 1084 (1913); 2 *FLETCHER*, Cyclopedia (1917) §§1134-5. Several exceptions are recognized. Thus, a corporation may take its own stock as security for an antecedent debt. Draper v. Blackwell, 138 Ala. 182, 35 So. 110 (1903). Or in compromise of a disputed claim or a hopeless debt. State v. Oberlin Bldg. Ass'rn, 35 Ohio St. 258 (1879). Or in case of the involvency of its debtor. Morgan v. Lewis, 46 Ohio St. 1, 17 N. E. 538 (1888). Or by way of gift or devise. 3 Gratt. (Va.) 19, 46 Am. Dec. 184 (1846).

\(^1\) The leading case of Trevor v. Whitworth, supra note 2, lays down these reasons which have been generally followed. If the corporation plans to reissue the shares, it is an unauthorized trafficking in its shares; if it does not plan to reissue them, it is an illegal reduction of its capital stock.


\(^3\) Johnson County v. Thayer, 94 U. S. 45, 23 L. ed. 203 (1875); Sanger v. Upton, 91 U. S. 56, 23 L. ed. 220 (1875); Hamor v. Taylor-Rice Eng. Co., 84 Fed. 392 (C. C. Del. 1897). Thus, under either rule, the purchase is invalid where the capital stock is impaired, or where the corporation is insolvent, or the effect of the purchase is to render the corporation insolvent. In re Tichenor Grand Co., 203 Fed. 720 (S. D. N. Y. 1913); Coleman v. Tepel, 230 Fed. 63 (C. C. A. 4th, 1916); Crandal v. Lincoln, 52 Conn. 73, 52 Am. Rep. 560 (1884); In re Columbian Bank, 147 Pa. 422, 23 Atl. 625 (1892); Olmstead v. Vance & Jones Co., 196 Ill. 236, 63 N. E. 634 (1902). Generally, a purchase will be sustained where the corporation has sufficient surplus at the time of the purchase. Contra: In re Pechheimer-Fischel Co., 212 Fed. 357 (C. C. A. 2d, 1914), which holds that although there is a surplus at the time of the purchase, if when the purchase price becomes due there is not sufficient surplus, the purchase will not be sustained. This holding has received little support, and has been adversely criticized. Note (1914) 14 Col. L. Rev. 451; Note (1914) 27 Harv. L. Rev. 747.

\(^4\) The theory that the capital stock of a corporation becomes a trust fund for the benefit of creditors upon the insolvency of the corporation has been generally recognized. 91 U. S. 45, 23 L. ed. 203 (1875); Sanger v. Upton, 91 U. S. 56, 23 L. ed. 220 (1875); Hamor v. Taylor-Rice Eng. Co., 84 Fed. 392 (C. C. Del. 1897). Thus, under either rule, the purchase is invalid where the capital stock is impaired, or where the corporation is insolvent, or the effect of the purchase is to render the corporation insolvent. In re Tichenor Grand Co., 203 Fed. 720 (S. D. N. Y. 1913); Coleman v. Tepel, 230 Fed. 63 (C. C. A. 4th, 1916); Crandal v. Lincoln, 52 Conn. 73, 52 Am. Rep. 560 (1884); In re Columbian Bank, 147 Pa. 422, 23 Atl. 625 (1892); Olmstead v. Vance & Jones Co., 196 Ill. 236, 63 N. E. 634 (1902). Generally, a purchase will be sustained where the corporation has sufficient surplus at the time of the purchase. Contra: In re Pechheimer-Fischel Co., 212 Fed. 357 (C. C. A. 2d, 1914), which holds that although there is a surplus at the time of the purchase, if when the purchase price becomes due there is not sufficient surplus, the purchase will not be sustained. This holding has received little support, and has been adversely criticized. Note (1914) 14 Col. L. Rev. 451; Note (1914) 27 Harv. L. Rev. 747.

\(^5\) Wyo. COMP. STAT. ANN. (1920) §5056; Ky. STAT. (Carroll, 1930) §544. Other states have statutes which, though they contain no express prohibition, have been construed as having such. Steele v. Farmers’ & Merchants’ Mutual
authorize such purchase under certain restrictions.\(^8\) Sound arguments can be made to sustain both views.\(^9\) Commentators, as well as the courts, are in direct conflict.\(^10\) The modern trend seems to be toward the majority American view, and there is some evidence that modern business approves of the practice.\(^11\)

The courts are likewise divided upon the validity of an agreement by a corporation to repurchase stock from a stockholder who has bought with such an understanding.\(^12\) Courts following the


\(^8\) Arguments for giving corporations such power: (1) gives the corporation greater flexibility; (2) enables corporations to remove undesirable stockholders; (3) allows for employee stock-holding schemes. See as an excellent article sustaining such power, Wormser, The Power of a Corporation to Acquire Its Own Stock (1915) 24 Yale L. Rev. 177. Arguments against giving corporation such power: (1) enables corporation to speculate in its own stock; (2) permits preferences to favored stockholders; (3) provides illegal method for reducing capital stock; (4) gives opportunity for abuse in corporate management. See Levy, Purchase By a Corporation of Its Own Stock (1930) 15 Minn. L. Rev. 1.


\(^10\) An examination of recent corporate balance sheets shows that a large number of corporations carry treasury stock either at cost or at market. See report of an address before the New York State Bankers' Association by Mr. J. Stewart Baker, president of the association, in The Washington Star of June 14, 1932, urging corporations to utilize surplus cash for the purchase of their securities at this time to check further declines. But see an article in The Chicago Tribune of Feb. 22, 1932, commenting on Wall Street brokers' statements that such practice leads to many abuses. See full page advertisement in U. S. Daily, Nov. 14, 1932, at 1657, and an article in Baltimore Sun, Nov. 16, 1932, indicating possible abuses.

\(^11\) Agreements to repurchase stock sold by a corporation must be distinguished from subscriptions to stock made with a secret agreement whereby the subscriber is given the privilege of returning the stock and recovering the money paid thereon. The former pertains to property belonging entirely to the corporation and may be dealt with as the company sees fit, just as any other chattel which it might own. The latter type of agreement is definitely tied up with the rights of subscribers as a whole, and any such secret agreement is a fraud on them, and is uniformly held to be unenforceable. Burke v. Smith, 16 Wall. 390, 21 L. ed. 361 (1872) ; Scovill v. Thayer, 105 U. S. 143, 26 L. ed.
American view uniformly hold that such a repurchase agreement is valid and enforceable where the purchase does not impair the capital stock.\textsuperscript{13} On the other hand, possibly a majority of the courts which follow the English view that a corporation has no power to purchase its own stock, nevertheless uphold the validity of repurchase agreements.\textsuperscript{14} Such a holding is explained by a variety of reasons. Some courts hold that a sale with a repurchase agreement is conditional.\textsuperscript{15} Since the purchaser does not get an absolute title, there is no sale, and hence, no illegal purchase by the corporation. Other courts hold that the contract of sale and repurchase is one entire contract; therefore, the corporation cannot repudiate the repurchase agreement and ratify the sale, but is liable for the purchase price as for money had and received.\textsuperscript{16} Other jurisdictions, even where there are statutes prohibiting corporations from purchasing their own stocks, construe the prohibition as not applying to treasury stock as distinguished from stock of the original issue.\textsuperscript{17}

\textsuperscript{18} 968 (1881); Marles Carved Moulding Co. v. Stuhl, 215 Pa. 91, 64 Atl. 431 (1906); Sarbach v. Kansas Fiscal Agency Co., 86 Kan. 734, 122 Pac. 113 (1912); Boushell v. Stroanch, 172 N. C. 273, 90 S. E. 198 (1916); \textsuperscript{2} \textit{FLETCHER, Cyc. Corp.} (1917) §§606, 607.

\textsuperscript{19} \textit{Vent v. Duluth Coffee & Spice Co., 64 Minn. 307, 67 N. W. 70 (1896); Fremont Carriage Co. v. Thomsen, 65 Neb. 370, 91 N. W. 376 (1902); Wisconsin Lumber Co. v. Greene & Western Tel. Co., 127 Iowa 350, 101 N. W. 742, 69 L. R. A. 968 (1904); Watson v. Virginia-Carolina Lumber Co., 93 S. C. 1, 75 S. E. 1020 (1912); Paulsen v. Weeks, 80 Ore. 468, 157 Pac. 590 (1916); 5 \textit{THOMPSON, op. cit. supra} note 5, §4086. Of course, in order to hold a corporation on an agreement to repurchase, it must be established that the agent was authorized to make such an agreement, or that the corporation ratified the act. Ordinarily, the managing officers of a corporation may bind it on a contract of repurchase. Phillips v. Riser, 8 Ga. App. 634, 70 S. E. 79 (1911); Trenholm v. Kloepfer, 88 Neb. 236, 129 N. W. 436 (1911); Murray v. Standard Pecan Co., 309 Ill. 226, 140 N. E. 834 (1923); 5 \textit{THOMPSON, loc. cit. supra}. If the length of the option is specified in the agreement, it must be exercised within a reasonable time after the expiration of the agreed period. New Haven Trust Co. v. Gaffney, 73 Conn. 480, 47 Atl. 760 (1901). If no time is fixed (as in the principal case) the purchaser must exercise his right within a reasonable time. \textit{Roush v. Ill. Oil Co., 180 Ill. App. 346 (1913).}


\textsuperscript{23} \textit{Kom v. Cody Detective Agency, 76 Wash. 540, 136 Pac. 1155, 50 L. R. A. (N. S.) 1073 (1913); Wilson v. Torchon Lace & Mercantile Co., \textit{supra} note
Only a very few jurisdictions hold that such repurchase agreements are unenforceable.\(^1\) No case has been found in North Carolina involving a repurchase agreement, but since this jurisdiction permits a corporation to purchase its stock,\(^2\) there seems little doubt that the Supreme Court will hold such an agreement valid.

This apparent effort of the courts to give effect to repurchase agreements can perhaps be explained by the general desirability and usefulness of such agreements. They form a necessary adjunct to most employee stock-holding schemes, enabling employees to share in the profits of the business.\(^3\) Further, this type of agreement aids in inducing otherwise reluctant investors to purchase corporate stock.\(^4\) Undoubtedly, however, opportunity is given for the creation of a favored class of stockholders to the possible detriment of non-assenting stockholders.\(^5\) Such a possibility is well illustrated in the principal case, where the favored stockholder is allowed to dispose of his stock to the corporation at a price five times greater than the market value. If the stockholders consider such discrimination unfair, they should be allowed to prevent it by a specific corporate by-law or charter restriction; for a general legislative prohibition, in attempting to stamp out possible abuses, would make unavailable the beneficial effects of repurchase agreements.

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Husband and Wife—Presumptions—Transfer of Property From Wife to Husband.

Husband and wife owned land; the profits therefrom and the proceeds of a sale of it were invested by the husband in his business. After judgment against him by a creditor, the husband executed a

2; Mulford v. Torrey Exploration Co., \textit{supra} note 14. See Note (1927) 36 Mich. L. Rev. 790 at 794 to the effect that such a distinction is not generally recognized.

\(^2\) Civil Service Inv. Ass'n v. Thomas, 138 Tenn. 77, 195 S. W. 775 (1917); Morrill v. Mastin, 23 N. M. 563, 170 Pac. 45 (1918); Pothier v. Reid Air Spring Co., 103 Conn. 380, 130 Atl. 383 (1925). But cf. Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1928).

\(^3\) Cases cited \textit{supra} note 4.

\(^4\) Levy, \textit{supra} note 9, at 2 and 32; Fordham, \textit{Some Legal Aspects of Employee Stock Purchase Plans} (1930) 8 N. C. L. Rev. 161.

\(^5\) It is obvious, of course, that a purchase with such an agreement presents an attractive investment, for it gives the purchaser an opportunity to escape what might be a bad investment. Vent v. Duluth Coffee & Spice Co., \textit{supra} note 13; Schulte v. Blvd. Gardens Land Co., \textit{supra} note 14.

\(^6\) Levy, \textit{supra} note 9, at 7 and 34. The author severely criticizes such stock-selling schemes, pointing out the abuses which are often attendant upon such practices.