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PAYMENT FOR REPURCHASED SHARES UNDER THE
TEXAS BUSINESS CORPORATION ACT

by

Robin P. Hartmann* and Robert E. Wilson**

A PLETHORA of laws regulates a corporation’s repurchase of its own shares. For instance, federal securities laws, like some blue sky laws, seek to prevent fraud and to provide full and fair disclosure in a corporation’s share repurchases; federal income tax laws prevent a bail-out of earnings and profits at lower capital gains rates in redemptions of shares which involve distributions essentially equivalent to a dividend; and federal banking laws prohibit national banks from purchasing their own shares except to prevent loss on debt previously contracted in good faith. In addition, common-law equitable standards restrict the power of a corporation to purchase its own shares in certain types of transactions. Supplementing these legislative and
judicial limitations, individuals and corporations are permitted reasonable control over a corporation's acquisition of its own shares.8

The most frequently encountered limitations on share repurchase transactions are the financial requirements imposed by modern state business corporation acts. The paradigm for these codifications, the Model Business Corporation Act (Model Act), confines routine repurchases of shares to acquisitions out of earned surplus, although amounts of capital surplus and stated capital may be used on certain occasions or to accomplish designated purposes.6 These financial prerequisites, deliberately tailored to parallel the financial requirements imposed upon the payment of dividends7 and upon distributions in partial liquidation,8 find their viability in statutory sanctions for transactions outside the stringently prescribed legal funds.9

When proposed as a part of the modern business corporation acts in the 1950's, this scheme of regulating corporate repurchases of shares by the use of financial requirements armed with remedial support was the subject of harsh criticism from the majority of legal scholars, who desired more prophylactic statutes.10 However, since adoption by a number of states11 which have followed the Model Act, this scheme has garnered minimal criticism because it has met "the needs of corporate management for efficiency and flexibility, while at the same time safeguard[ed] the interests of shareholders, of creditors, and of the public."12 Though working satisfactorily most of the time, some peculiar problems have arisen from court construction of these share repurchase statutes.

The application of these statutes to the transaction in which the purchase

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8 TICE § 495 (1959); purchasing shares of minority shareholders for abusive reasons (State v. Miller-Wohl Co., 42 Del. 73, 28 A.2d 148 (Super. Ct. 1942)); manipulating market prices (Stella v. Kaiser, 82 F. Supp. 301 (S.D.N.Y. 1948)); purchasing stock of minority shareholders to favor insiders on liquidation (Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947)); and maintaining equality of opportunity to sell shares to the corporation (Reifsnyder v. Pittsburgh Outdoor Advertising Co., 396 Pa. 320, 152 A.2d 894 (1959)).

9 Contractual limitations may be found in articles of incorporation, bylaws, senior securities, and loan agreements. These limitations must be reasonable. See, e.g., Ling & Co. v. Trinity Sav. & Loan Ass'n, 470 S.W.2d 441 (Tex. Civ. App.—Waco 1971), rev'd, 482 S.W.2d 841 (Tex. 1972), noted in 50 TEXAS L. REV. 528 (1972). See generally 2 F. O'NEAL, CLOSE CORPORATIONS § 7.08 (1958).

10 See, e.g., TEX. BUS. CORP. ACT ANN. art. 2.38 (1956).

11 See, e.g., id. art. 2.40.

12 Ballantine, Questions of Policy in Drafting a Modern Corporation Law, 19 CALIF. L. REV. 465 (1931); Dodd, Jr., Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 89 U. PA. L. REV. 697 (1941); Glenn, Treasury Stock, 15 VA. L. REV. 625 (1929); Levy, Purchase by a Corporation of Its Own Stock, 15 MINN. L. REV. 1 (1930); Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 COLUM. L. REV. 971 (1935); Wormser, The Power of a Corporation To Acquire Its Own Stock, 24 YALE L.J. 177 (1915).

While there are no jurisdictions which have provisions identical to the Model Act, two states have statutes identical in substance, and seventeen other states have statutes comparable to the provisions of the Model Act. See generally MODEL BUS. CORP. ACT ANN. § 6, ¶ 3 (2d ed. 1971). There can be little doubt that the Model Act has influenced corporate statutes in all states. See Kessler, Share Repurchases Under Modern Corporation Laws, 28 FORDHAM L. REV. 637 (1959-60), for an excellent analysis of the Model Act and its adherents.

13 Foreword by Dean Page Keeton, in SPECIAL COMMITTEE ON REVISION OF CORPORATION LAWS OF TEXAS STATE BAR, PROPOSED TEXAS BUSINESS CORPORATIONS ACT (1951).
price of shares is evidenced by a promissory note of the repurchasing corporation or when the purchase price is deferred or payable in installments has spawned litigation, which in turn has produced problems for the corporation, for creditors, and for shareholders. For example, court decisions have interpreted statutes like article 2.03 of the Texas Business Corporation Act (TBCA) as requiring the repurchase of shares only with cash or tangible assets which must leave the corporation at a time when surplus exists equal to the purchase price. The contingency of future surplus adequate to satisfy this construction of statutes akin to article 2.03 is tantamount to the elimination of corporate evidences of indebtedness as consideration for a corporation's repurchase of its own shares. In this cashless age where sophisticated corporate finance often dictates high leverage, the preference for cash over debt transactions seems an anachronism, and puts states with statutes similar to article 2.03 at a disadvantage in attracting and competing for new corporate residents. Moreover, this construction (that repurchased shares are paid for only when cash leaves the corporation at a time when surplus exists equal to the purchase price) carried to its logical extreme, appears to cause article 2.03 of the TBCA to be inconsistent with provisions of the Texas Business and Commerce Code. Adding even more confusion, this obscure inconsistency and awkward preference is encouraged by article 2.16(B) of the TBCA, but hindered by article 2.03(E) of the TBCA. These contradictions and outdated preferences can only be eliminated by remedial legislation.

I. THE NO PREJUDICE RULE AND THE INSOLVENCY CUTOFF

The present treatment of purchases by a corporation of its own shares developed in two stages. Initially, the question was: may a corporation lawfully purchase its own shares? An affirmative, though not unanimous, response led to the next question: when—or to what extent—may a corporation lawfully purchase its own shares? Before the modern business corporation acts, a hodgepodge of vague phrases such as "no prejudice to the rights of creditors," "ultra vires transactions," and "impairment of capital" served as nebulous guidelines for determining when repurchase transactions were lawful. Of these ephemeral judicial standards, the no prejudice rule became the popular view.

Determining exactly when a repurchase transaction becomes prejudicial to creditors is not easy, but it is essential to an understanding of judicial interpre-

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13 Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960).
14 See TEX. BUS. & COMM. CODE ANN. § 1.201(a)(4) (1968). See also note 42 infra.
15 TEX. BUS. CORP. ACT ANN. art. 2.16(B) (1956) provides that the issuance of a promissory note does not constitute payment for shares of a corporation.
16 Id. art. 2.03(E) provides that the surplus restriction requirement is dissolved by cancellation of the repurchased shares without regard to the form of payment used to acquire the shares.
17 Early American authority decided that a corporation may acquire its own shares in exchange for debt due it. Ex parte Holmes, 5 Cow. 426 (N.Y. Sup. Ct. 1826).
18 Trevor v. Whitworth, 12 App. Cas. 409 (1887), established the English rule, which exists to date, that an English corporation cannot purchase its own shares. The reasoning of that decision was simple: the court could find no legitimate reason for a corporation's purchasing its own stock.
tations of share repurchase sections found in state business corporation acts. The basic rule was that once a corporation became insolvent, a repurchase of shares was no longer permissible, since the payment for worthless shares invariably involved a fraudulent conveyance of the assets which were used to make payment.\footnote{Boggs v. Fleming, 66 F.2d 859 (4th Cir. 1933); Barden v. A. Heller Sawdust Co., 240 Mich. 549, 215 N.W. 364 (1927).} Undoubtedly, the exchange of valuable assets for worthless shares worked to the prejudice of creditors' rights. The no prejudice rule did not, however, reach repurchases consummated while the corporation was solvent, even when the repurchase impaired the capital of the corporation or was followed closely by insolvency.\footnote{Herwitz, supra note 19, at 306.} In a nutshell, the rule minus the exceptions left the critical determination of the legality of share repurchases dependent upon two factors: the date of insolvency and the date of repurchase. If the repurchase preceded insolvency, the transaction was lawful, while if repurchase followed insolvency, it was illegal.

Application of this seemingly arbitrary rule faltered, however, when the payment of the purchase price was deferred, payable in installments, or evidenced by a promissory note. "Was the critical time when the repurchase agreement was executed, or the date on which the price was due?"\footnote{Id. at 307.} Most courts took the position that the result should not be different merely because the purchase price was deferred, payable in installments, or evidenced by a promissory note, rather than initially paid in a lump sum. Solvency at the date of payment (when assets left the corporation to pay the deferred price, an installment, or the promissory note) was a condition precedent, and any payment on a repurchase obligation or promissory note after insolvency was regarded as fraudulent and prejudicial. This reasoning is best illustrated in the Fifth Circuit decision in \emph{Robinson v. Wangemann}:\footnote{75 F.2d 756, 757-58 (5th Cir. 1935).}

Arthur Wangemann loaned no money to the corporation. The note he accepted for his stock did not change the character of the transaction nor did the renewals have that effect. A transaction by which a corporation acquires its own stock from a stockholder for a sum of money is not really a sale. The corporation does not acquire anything of value equivalent to the depletion of its assets, if the stock is held in the treasury, as in this case. It is simply a method of distributing a proportion of the assets to the stockholder. The assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full. When such a transaction is had, regardless of the good faith of the parties, it is essential to its validity that there be sufficient [excess of assets over liabilities] . . . to retire the stock, without prejudice to creditors, at the time payment is made out of assets. In principle, the contract between Wangemann and the corporation was executory until the stock should be paid for in cash. It is immaterial that the corporation was solvent and had sufficient [excess of assets over liabilities] . . . to make payment when the agreement was entered into. It is necessary to a recovery that the corporation should be solvent and have sufficient [excess of assets over liabilities] . . . to prevent injury to creditors when the payment is actually made. This was an implied condition in the original note and the renewals accepted by Arthur Wangemann.\footnote{Id. at 307.}
Wolff v. Heidritter Lumber Co., one of the few cases not agreeing with the reasoning of Robinson, contains equally logical arguments to the contrary:

[O]n reason and authority the conclusion seems inescapable that a corporation may purchase shares of its own stock, for 'legitimate corporate purposes,' and may, instead of paying cash therefor, issue its obligation payable at a future date, and that the vendor holding such obligation becomes forthwith a creditor, instead of a stockholder, of the company and entitled to rank equally with other creditors in the event of subsequent insolvency of the company, provided that at the time of the purchase the company has sufficient assets to pay its creditors in full and provided the purchase is not made in disregard of the equitable rights of other stockholders. 24

The Wolff argument was convincing to few. Most courts followed the reasoning of Robinson, viewing a contract to repurchase shares, insofar as the corporation was concerned, as executory until cash was received for those shares. The concern to creditors and other shareholders was the time the assets left the corporation, since that was when the concomitant reduction in protection occurred. Therefore, payment for the shares occurred when the assets left the corporation, not when the contract was executed or when the promissory note was issued. As a result, the shareholder who resold his shares to the corporation in exchange for a promissory note received that note subject to automatic subordination to all other claims against the corporation upon the corporation's subsequent insolvency; or, if he received a deferred payment obligation, he had contracted to receive payment for the shares if, but only if, the corporation remained solvent. In sum, prior to enactment of the modern business corporation acts, the date of insolvency was the cutoff between lawful and unlawful purchases by a corporation of its own shares, and payment for repurchased shares meant the time cash or tangible assets actually left the corporation.

II. MODERN BUSINESS CORPORATION ACTS—THE SURPLUS LIMITATION

With the movement for modernization of corporate laws came the heated argument over the handling of a corporation's acquisitions of its own shares. Two schools of thought evolved: (1) the paternalistic view that at common law management's almost free rein to have a corporation repurchase its own shares allowed abuse of unwitting creditors and shareholders, and, therefore, that the scope of legitimate repurchases must be exactly defined in prophylactic statutes; and (2) the remedial approach, which restricted management's scope of discretion to have a corporation repurchase its own shares by providing remedies for purchases in violation of prescribed standards. Adherents to the paternalistic view thought creditor and shareholder protection could be attained only by confining the discretion of management and insiders to repurchases solely out of earned surplus. 25 Some even wanted to enumerate the exact circumstances under which the power of repurchase could be used,

24 112 N.J. Eq. 34, 163 A. 140, 141 (Ch. 1932).
thereby completely eliminating the potential danger to creditors and shareholders. Those supporting this approach seemed to presume unscrupulous and overreaching management, and situations where insiders would take advantage of more liberalized statutes to eliminate minority shareholders, to bail-out favored shareholders at the first glimmer of trouble, to compromise debts to insiders, to siphon off assets of the corporation, and to accomplish other self-dealing ends.

Supporters of the remedial procedure viewed this protective approach as unnecessarily dispensing with a variety of share repurchase transactions which are prompted by legitimate business purposes and circumstances. In any event, they argued, equity prevents, to the same extent as a paternalistic statute, overreaching by insiders.

The compromise struck was to upgrade the no prejudice rule (or insolvency cutoff test) to a surplus cutoff, which required that all purchases by a corporation of its own shares be out of surplus. Repurchases out of earned surplus are permitted for any legitimate corporate purpose, and other amounts of surplus would be available under prescribed conditions.

Article 2.03 of the TBCA is typical of the compromise. It allows a corpora-

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28 Kessler, supra note 11.
27 See Z. CAVITCH, BUSINESS ORGANIZATIONS § 147.02, at 807 (1965).
28 TEX. BUS. CORP. ACT ANN. art. 2.03 (1956) reads as follows:

A. A corporation shall not purchase directly or indirectly any of its own shares unless such purchase is authorized by this Article and not prohibited by its articles of incorporation.

B. A corporation may purchase its own shares to the extent of the aggregate of any unrestricted surplus available therefor and its stated capital when the purchase is authorized by the directors, acting in good faith to accomplish any of the following purposes:

1. To eliminate fractional shares.
2. To collect or compromise indebtedness owed by or to the corporation.
3. To pay dissenting shareholders entitled to payment for their shares under the provisions of this Act.
4. To effect the purchase or redemption of its redeemable shares in accordance with the provisions of this Act.

C. Upon resolution of its board of directors authorizing the purchase and upon compliance with any other requirements of its articles of incorporation, a corporation may purchase its own shares to the extent of unrestricted earned surplus available therefor if accrued cumulative preferential dividends and other current preferential dividends have been fully paid at the time of purchase.

D. Upon resolution of its board of directors and vote of the holders of at least two-thirds of all shares of each class, voting separately, authorizing the purchase and upon compliance with any other requirements of its articles of incorporation, a corporation may purchase its own shares to the extent of the aggregate of unrestricted capital surplus available therefor and unrestricted reduction surplus available therefor.

E. To the extent that earned surplus, capital surplus or reduction surplus is used as the measure of the corporation's right to purchase its own shares, such surplus shall be restricted so long as such shares are held as treasury shares, and upon the disposition or cancellation of any such shares the restriction shall be removed pro tanto as to all of such restricted surplus not eliminated thereby.

F. In no case shall a corporation purchase its own shares when there is a reasonable ground for believing that the corporation is insolvent, or will be rendered insolvent by such purchase or when, after such purchase, the fair value of its total assets will be less than the total amount of its debts.

G. An open-end investment company, registered as such under the Federal Investment Company Act of 1940, as heretofore or hereafter amended, if
tion to acquire its own shares to the extent of the available:

(a) earned surplus, to accomplish any legitimate purpose, but only if the articles of incorporation permit repurchases and if accrued cumulative preferential dividends have been fully paid; or

(b) capital surplus and reduction surplus, for any legitimate purpose, but only if two-thirds of all shares of each class of stock approve such acquisition; or

(c) capital surplus and stated capital, in four isolated instances.

Also qualifying any repurchase is the requirement that the corporation be solvent in the equity sense and the bankruptcy sense at the time of repurchase. Thus, the drafters of the modern business corporation acts raised the standards prerequisite to a lawful purchase by a corporation of its own shares—the insolvency cutoff became the surplus cutoff. The question was no longer whether the corporation was solvent at the time it purchased its own shares, but whether the corporation had sufficient surplus at the time it purchased its own shares.

A problem arose with the application of the surplus cutoff statute in the situation where the purchase price was deferred, payable in installments pursuant to a contract, or evidenced by a promissory note. Should the surplus test be applied at the time the promissory note was issued in exchange for the repurchased shares, or at the time cash left the corporation to liquidate the promissory note? Should the surplus test be applied to each installment payment as it becomes due under the contract, or to the aggregate purchase price at the time of execution of the repurchase agreement? Undoubtedly, the common-law insolvency cutoff rule would apply at the time cash left the corporation; that is, when the promissory note became due or an installment payment accrued. Arguably, the statutory surplus test should be imposed at the same point in time unless some overriding policy dictated otherwise.

Regrettably, the court decisions since the passage of the modern state business corporation acts have failed to consider whether or not sufficient reasons exist to apply the statutory surplus limitations and the common-law insolvency test.

its articles of incorporation shall so provide, may purchase, receive, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares, out of stated capital or any unrestricted surplus.

29 Model Bus. Corp. Act Ann. § 2(n) (2d ed. 1971) and Tex. Bus. Corp. Act Ann. art. 1.02(16) (1956) both define "insolvency" to mean "the inability of a corporation to pay its debts as they become due in the usual course of its business." However, Texas' repurchase of shares statute contains a phrase not found in the Model Act, namely, "in no case shall a corporation purchase its own shares when . . . the fair value of its total assets will be less than the total amount of its debts." Tex. Bus. Corp. Act Ann. art. 2.03(F) (1956). As the Supreme Court has held, "[i]nsolvency in the equity sense has always meant an inability of the debtor to pay his debts as they mature. Under the Bankruptcy Act it means an insufficiency of assets at a fair valuation to pay debts." Finn v. Meighan, 325 U.S. 300, 303 (1945). Thus, while the TBCA requires solvency both in the equity sense and the bankruptcy sense, the Model Act requires solvency only in the equity sense. Maryland and North Carolina also incorporate both insolvency tests into their surplus statutes. Md. Ann. Code art. 23, § 32(c) (1966); N.C. Gen. Stat. § 55-52(e) (1965).

Why Texas, Maryland, and North Carolina use insolvency both in the equity sense and in the bankruptcy sense to limit repurchases is unexplained. A corporation with surplus can be insolvent in the equity sense, but can a corporation have a surplus if it is insolvent in the bankruptcy sense? See Kessler, supra note 11, at 666 n.95.
at different times. Usually, though not always, the courts selected the easier alternative and imposed the two tests at the same time.

For example, in *Mountain State Steel Foundries, Inc. v. Commissioner* the Court of Appeals for the Fourth Circuit held that a West Virginia corporate statute, which prohibited the use of corporate funds for the purchase of the corporation's shares if such a purchase would cause any impairment of the corporation's capital, required that each installment of the purchase price for reacquired shares be covered by surplus as that installment accrued. It was immaterial whether the corporation had surplus equal to or in excess of the total purchase price on the date of execution of the repurchase contract and surrender of the purchased shares. "In effect, the *Mountain State* holding means that an installment repurchase transaction is to be treated as if the successive installments constituted a series of independent repurchase transactions, each of which is to be tested separately under the [surplus cutoff test].""31

Similarly, the court in *In re Mathews Const. Co.* was concerned with the validity of a promissory note, issued by a California corporation as partial consideration for the acquisition of some of its own shares, under a corporate statute similar to article 2.03 of the TBCA. At the time the promissory note was issued in 1949, the financial requirements of the California statute were satisfied, but bankruptcy intervened in 1952 and thereafter there was no surplus. Citing both the California surplus statute and an insolvency cutoff case, the court held the note was unenforceable because: "Bankruptcy having intervened, obviously there can be no surplus from which payment for repurchased stock may be made.""32 In effect, the *Mathews* decision means that the statutory surplus requirements apply at the same time as the common law insolvency test—which is at the time assets physically leave the corporation and not when the promissory note is issued in exchange for the shares. Moreover, issuance of a negotiable promissory note in the purchase by a California corporation of its own shares is not "payment" since the shares are not paid for until the promissory note is paid. The *Mountain State* and *Mathews* decisions, both of which involved construction of statutory surplus requirements, indiscriminately followed the reasoning of the 1935 Robinson opinion, which involved the common-law insolvency cutoff test.

On the other hand, in the Minnesota case of *Tracy v. Perkins-Tracy Printing Co.* the court was faced with the construction of a surplus statute, but there the court followed the reasoning of the *Wolff* decision. A shareholder had sold his shares to the corporation for a promissory note secured by chattel mortgages. The court, giving great weight to the fact that the promissory note was secured, concluded that the "corporation having had adequate surplus funds on the date the agreement was made [and the promissory note issued] to cover the entire purchase price of the stock, the liens of the chattel mortgages were not affected by the subsequent depletion of corporate surplus.""33

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"31 See 284 F.2d 737 (4th Cir. 1960).
"32 Herwitz, supra note 19, at 304.
"34 Id. at 821.
"35 278 Minn. 159, 153 N.W.2d 241 (1967).
"36 Id. at 245.
Thus, the surplus requirements of the Minnesota statute were applied on the
date of execution of the repurchase agreement and issuance of the promissory
note, not on the date the assets left the corporation. Tracy clearly held that the
issuance of a secured promissory note was payment for the repurchased shares.

At this point it does not appear firmly settled whether the statutory surplus
requirements, as they apply to purchases by corporations of their own shares
where the purchase price is paid in installments or deferred pursuant to a
contract or evidenced by a promissory note, must be applied at the outset to
the total purchase price, or at some later date when cash leaves the corporation.
Admittedly, the construction adopted by Mountain State and Mathews has the
upper hand, but these decisions are not very persuasive since they have not
considered the consequences which follow this application, let alone any
alternative interpretations. Since quite disparate consequences result from appli-
cation of the surplus statute at the outset as opposed to application when cash
leaves the corporation, careful consideration must be given to determine which
application is the fairest for all those concerned.

III. SURPLUS REQUIREMENTS OF THE TBCA

Article 2.03 of the TBCA provides that a corporation may purchase its own
shares only when there is sufficient surplus, and that in no event shall a cor-
poration purchase its own shares when there are reasonable grounds for be-
lieving that the corporation is insolvent or would be rendered insolvent by such
purchase. Obviously the proper application of the surplus limitation of article
2.03 is on the date the corporation purchases its own shares. But regretfully,
the term "purchase" is not defined in the TBCA. Purchase could be deemed to
be (1) at the outset when a repurchase contract is executed or a promissory
note is issued in exchange for the shares, or (2) at some later point in time
when cash leaves the corporation pursuant to the repurchase contract or to
pay the note at maturity. Without a statutory definition, the issue should be
decided by considering the intent of the drafters of the statute and after con-
trasting the merits of each application.

Since the drafters of the TBCA wisely borrowed heavily from the Model
Act, the intent of the Model Act architects often gives a helpful clue to the
proper interpretation to be given a TBCA section. Such a hint comes from a
1957 amendment to the Model Act, which to date has not been adopted as
a part of the TBCA. This amendment clarified the term "purchase" to refer
to the time a repurchase of shares contract is executed or promissory note is
issued in exchange for shares, rather than the date cash leaves the corporation
pursuant to the contract or to pay the promissory note. That amendment to
the Model Act added the words "or payment for" to the insolvency cutoff test.
The Model Act section now provides, in part, that:

A corporation shall have the right to purchase, take, receive or otherwise
acquire, hold, own, pledge, transfer or otherwise dispose of its own shares,
but purchases of its own shares ... shall be made only to the extent of un-
reserved and unrestricted earned surplus available therefor ... [and if certain
conditions are met], to the extent of unreserved and unrestricted capital sur-
plus available therefor.
No *purchase of or payment for* its own shares shall be made at a time when the corporation is insolvent or when such purchase or payment would make it insolvent.\(^6\)

Professor Herwitz views this change as an intentional effort by the draftsmen to distinguish prerequisites to "payments" from prerequisites to "purchases." The draftsmen understood that the term "purchase" and the term "payment" would apply to the insolvency cutoff provision, but by making no change in the surplus restrictions, they intended that only "purchases" and not "payments" be covered by the surplus provisions. In other words, a corporation must be solvent and have a surplus on the date it purchases its own shares, and must be solvent, though it need not have a surplus, on the date of payment for the shares.\(^7\) Accordingly, the inference is well nigh irresistible that the surplus test is to be applied to the total repurchase obligation at the outset [when the agreement is executed or a note exchanged for shares], and not to any subsequent payments as they are made [pursuant to the agreement or to pay the promissory note].\(^8\)

Since the TBCA is based on the Model Act, some weight must be given to the intent of the framers of the Model Act, which was to have the surplus limitations apply at the outset when shares are surrendered in exchange for value from the corporation, rather than on the date cash leaves the corporation as payment. However, the scales are evenly balanced if the Texas Legislature's inaction in failing to adopt the 1957 change to the Model Act has been intentional. This is unlikely since some support for Professor Herwitz's argument can be implied from the TBCA. Article 2.03(E) provides that:

To the extent that earned surplus, capital surplus or reduction surplus is used as the measure of the corporation's right to purchase its own shares, such surplus shall be restricted as long as such shares are held as treasury shares, and upon the disposition or cancellation of any such shares the restriction shall be removed pro tanto as to all of such restrictive surplus not eliminated thereby.\(^9\)

The requirement is that surplus be maintained until the purchased shares are cancelled or disposed of otherwise. Once the shares are cancelled or disposed of otherwise, the requirement for maintaining surplus is absolved. There is no mention that a corporation must retain surplus until the date of payment, but merely that it must have surplus on the date of purchase, and maintain that surplus while such shares are held in the treasury. Clearly, article 2.03(E) permits the surplus requirement to be extinguished before cash leaves the corporation. To require a corporation that has cancelled repurchased shares to have a surplus when cash subsequently leaves the corporation as payment is to disregard article 2.03(E). Thus, the intent of the framers of the Model Act in distinguishing prerequisites for purchases from prerequisites for payments carried through into article 2.03(E). It appears to have been the intent of article 2.03 that a corporation must have surplus on the date it purchases its own shares, must maintain that surplus during the time the se-

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\(^6\) *MODEL BUS. CORP. ACT ANN.* § 6, ¶ 1 (2d ed. 1971) (emphasis added).

\(^7\) Herwitz, *supra* note 19, at 323.

\(^8\) *TEX. BUS. CORP. ACT ANN.* art. 2.03(E) (1956).
REPURCHASED SHARES

securities are held in the treasury, and must be solvent, but need not have a surplus on the date it makes a cash payment for those shares. If these arguments seem academic, theoretical, and of little concern to the practicing attorney, concrete practical reasons are readily available to support the position that the surplus limitations must be applied at the outset.

First, reason and sound business practice support treating the acquisition as final on the date the share repurchase agreement is made and the shares surrendered to the corporation, rather than leaving the repurchase contract indefinitely open until cash leaves the corporation. Most repurchase-of-shares agreements challenged under the common-law insolvency cutoff test were deemed executory until cash left the corporation. Most decisions since the modern repurchase-of-shares statutes have indiscriminately held repurchase contracts executory until the payment in cash, even though on the date of execution of the agreement the shares were surrendered for cancellation, the appropriate surplus account debited, and all shareholder rights and privileges surrendered by the selling shareholder. These latter decisions have failed to consider provisions such as article 2.03(E) and the 1957 amendment to the Model Act which infer that a repurchase contract is final on the purchase date or on the date the repurchased shares are cancelled or disposed of otherwise, whichever occurs last. Moreover, these decisions overlook the fact that a negotiable promissory note constitutes "payment" under the Texas Business and Commerce Code. That is, if a promissory note is used to repurchase shares, the purchase and payment occur simultaneously, thereby satisfying both the surplus and insolvency tests of article 2.03 at the outset. To require a surplus on the date the note is paid is directly in conflict with the Texas Business and Commerce Code. Indeed, such an imposition would require surplus in an amount twice the purchase price, since the appropriate surplus account would be debited at the outset, and then required to exist again when cash leaves the corporation to pay the note. Admittedly, article 2.61(B) of the TBCA expressly states that a promissory note is not payment or part payment for shares of a corporation, but, in context, this authority is virtually worthless as support for the executory nature of repurchase contracts, since article 2.16 was intended to dictate the proper consideration for issuances of shares. Needless to say, corporations daily repurchase their own shares in exchange for

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39 See notes 22, 23 supra, and accompanying text.
40 See, e.g., Mountain States Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), and text accompanying note 30 supra; In re Matthews Const. Co., 120 F. Supp. 818 (S.D. Cal. 1954), and text accompanying note 32 supra.
41 See TEX. BUS. & COMM. CODE ANN. § 1.201(44) (1968). See also note 42 infra.
42 In a contract entered into pursuant to the Texas Business and Commerce Code, the seller's rights in such object cease when value (§ 1.201(44)) passes from the purchaser to the seller, and the seller's rights in and to the object sold continue only if a security interest is retained (§ 2.401). Thus, if shares of stock were treated like every other thing under the Texas Business and Commerce Code, the seller's rights, interests, and privileges in and to the shares cease when "value," e.g., a promissory note, is issued to the seller by the purchaser. "Payment" occurs when "value" is transferred.
43 TEX. BUS. CORP. ACT ANN. art. 2.16(B) (1956), provides that, "Neither promissory notes nor the promise of future services shall constitute payment or part payment for shares of a corporation." But see Triumph Smokes, Inc. v. Sarlo, 482 S.W.2d 696 (Tex. Civ. App. —Tyler 1972).
promissory notes or debentures, and few would challenge such transactions as illegal under article 2.16(B).

The fact situation in Palmer v. Justice demonstrates the problems which can result from decisions like Mountain State and Mathews. In that case, shares of the common stock of Maxwell Electronics Corporation were surrendered in 1963 and cancelled during 1964, at which time the surplus account of the company was reduced by an amount equal to the value of the shares. The purchase price was represented by a promissory note of the corporation due in 1966. If the court had applied article 2.03 of the TBCA as required by Mountain State and Mathews, it would have required an amount of surplus equal to twice the amount of the purchase price of the shares. In 1966, when the note matured, the corporation would have had to have surplus available equal to the purchase price, despite the fact that the surplus had already been reduced by that amount in 1964. Further, to require the company to maintain surplus until 1966 after the repurchased shares had been cancelled in 1964, would have been to ignore completely article 2.03(E) of the TBCA. Also, the court would have to have held that the contract of repurchase entered into in 1963 was executory until 1966 when the note was paid, notwithstanding that the issuance of the negotiable promissory note constituted payment under the Texas Business and Commerce Code, and that the selling shareholders had relinquished in 1963 all rights and privileges as shareholders of the corporation. Indeed, the court would have had to create a new type of security holder, since between 1963 and 1966 the persons who had sold their shares to Maxwell could not be categorized either as shareholders or creditors. Such persons certainly were not shareholders, as they relinquished all voting rights, appraisal rights, dividend rights, and all other rights and privileges in their stock in 1963; and they could not be called full-fledged creditors, as their notes were enforceable only when and if the corporation ever had surplus equal to the purchase price. In this state of limbo, such persons might be called "subordinated contingent creditors." The court in Palmer v. Justice correctly held that the purchase and payment were made in 1963, thereby avoiding these problems.

Another problem with holding repurchase-of-shares agreements executory until cash leaves the corporation, and with applying the surplus requirements at that time, is the ease with which this impact can be avoided. To avoid decisions such as Mountain State and Mathews, a corporation need only purchase its own shares for cash, then have the former shareholder loan back to the corporation the cash received. To fall squarely in line with Tracy, the note should be secured. This preference of form over substance should find no comfort in this age of sophisticated corporate finance, and, therefore, some courts have looked through the form to the substance of the transaction. Yet this distinction without a difference has not always been disallowed as a subterfuge,

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44 322 F. Supp. 892 (N.D. Tex.), aff'd per curiam, 451 F.2d 371 (5th Cir. 1971).
45 See note 38 supra, and accompanying text.
and the possibility that it may work has often driven counsel to recommend the extra step.

Another problem in applying *Mountain State*, *Mathews*, and *Robinson* is that insiders may lawfully and purposefully defraud minority shareholders who have sold their shares to the corporation. In the commonplace situation where a dissenting minority shareholder in a small corporation has been bought out by the company, the corporation may purchase his shares for a promissory note; the insiders could then vindictively proceed to insure that surplus was never available to pay the note. This can be accomplished by the use of the power to declare dividends in an amount equal to the available surplus, and other perfectly legal methods of depleting surplus.

Other possible ramifications which can result from confusing the *Robinson* doctrine with the requirements of the statutory surplus statutes are provided by recent exchange offers. In 1968 and 1969 numerous corporations acquired their own common stock from public shareholders and issued debentures in exchange therefor. Under *Mountain State* and *Mathews* a court would be constrained to hold, if surplus now did not exist equal to the purchase price of the shares, that payment of interest on these debentures is unlawful, and that the underlying obligations themselves are inferior to all other general creditors. The inconsistency of the *Robinson* doctrine with modern business needs and practices is clear.

The current Penn Central reorganization demonstrates the shortcomings of incorporating the *Robinson* doctrine into modern repurchase-of-shares statutes. Former shareholders in Penn Central may in the past have exchanged their shares for debentures in the corporation when adequate surplus existed. The trustee would now be compelled to pursue a labyrinth of transfers through various financial portfolios to locate the present debentureholders. These debentureholders would then be declared inferior to other creditors and the possessors of contingent claims. It might be possible for these holders to pursue recovery back through the chain of ownership to the original purchaser of the debenture, but this avenue of recovery seems dim. It becomes once again painfully obvious that the needs of modern business practice cannot bear the strictures which the *Mountain State* and *Mathews* decisions impose. Negotiable instruments and evidences of indebtedness must be allowed to flow freely.

Numerous other problems have been recognized and discussed in this area. For example, accounting problems, treatment of treasury shares, and income tax problems present potential pitfalls. All of these problems point to the uncertain nature of the application of article 2.03 of the TBCA and the apparent need for change.

**IV. LIABILITY FOR WRONGFUL REPURCHASES**

If a Texas corporation wrongfully repurchases its own shares, statutory civil liability is imposed by article 2.41 of the TBCA jointly and severally upon the directors who voted for or assented to the transaction. The extent of lia-

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47 See Herwitz, note 19 supra.

48 TEX. BUS. CORP. ACT ANN. art. 2.41 (1956).
bility can be either the amount of consideration paid for the shares in excess of the maximum amount which could have been lawfully paid on the date of purchase or the aggregate amount of payments made. A director is exonerated if he (1) dissents in writing to the repurchase, (2) acts in reliance upon financial statements prepared by certain officers or accountants as to the financial condition of the corporation, or (3) in good faith and in the exercise of ordinary care relies on the written opinion of counsel to the corporation. Some protection is provided for liable directors who are entitled to contribution from shareholders who knowingly accept illegal payments and from other directors who vote for or assent to the repurchase. Texas, like most states, does not impose criminal liability for purchases in violation of the statute.

This civil liability imposed on directors by article 2.41(A) (2) is deceivingly narrow in coverage. First, the validity of a purchase by a corporation of its own shares may be challenged only by persons who are injured, or whose rights are prejudiced, and who have not approved the purchase. This eliminates, among others, as possible plaintiffs the corporation, shareholders who voted for or are not prejudiced by the transaction, existing creditors not injured, and subsequent creditors who become such with notice of the transaction. Next, misconduct and negligence are penalized by the statute, but some violations may be covered by an indemnification bylaw. And, as mentioned above, the assenting director who relies on certain financial statements of the corporation or on an opinion of counsel is relieved of liability. Ironically, the narrowness of article 2.41 is fortunate because of the number of repurchase transactions that appear legal on their face, but violate article 2.03 as construed by decisions such as Mountain State and Mathews. However, those transactions which fall outside the coverage of article 2.41 may violate other laws, such as the federal securities laws.

Grave consequences result from a wrongful repurchase of shares that inadvertently violates the federal securities laws. The coverage of the federal securities laws is daily growing so broad that, if the trend continues, few

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49 *Id.* arts. 2.41(A) (2), 2.41(A) (6).
50 *Id.* arts. 2.41(B), 2.41(C), 2.41(D).
51 *Id.* art. 2.41(E).
52 *Id.* art. 2.41(F).
53 Cf. N.Y. Penal Law § 190.35 (McKinney 1967), which makes it a misdemeanor to repurchase shares wrongfully.
54 Z. Cavitch, supra note 27, § 147.06, at 869. The recent case of Triumph Smokes, Inc. v. Sarlo, 482 S.W.2d 696 (Tex. Civ. App.—Tyler 1972), provides an excellent example of the narrowness of art. 2.41 of the TBCA. There, shareholders of Triumph Smokes exchanged shares of the common stock of Triumph Smokes for debentures of Triumph Smokes at a time when the corporation had no earned surplus. The debentures were unpaid at the time of trial, and the trial court granted summary judgment in favor of the debenture holders. The court of appeals affirmed the trial court's decision by holding that the purchase by a corporation of its own shares in contravention of art. 2.03 of the TBCA is not per se "illegal and void" but merely an act "without authority" and, therefore, voidable. The court further held the debentures were enforceable; whether the debentures in this case were in fact voidable was not decided, since the corporation cannot challenge the transaction. That is, "The validity of the purchase may not be attacked by the corporation itself." *Id.* at 698.
55 Tex. Bus. Corp. Act Ann. art. 2.02(A) (16) (1956) empowers a Texas corporation to indemnify certain persons except for negligence or misconduct in performance of their duty to the corporation, and to provide further for indemnification in bylaws, agreements, by a vote of shareholders, and otherwise.
violations of article 2.41(A)(2) may escape the ambit of the antifraud provisions of the federal securities laws. For example, as a leading authority regarding rule 10b-5 liability notes, "A startling variety of everyday transactions have turned out to be fraudulent under SEC Rule 10b-5." Indeed, with the attorney-client privilege and the indemnification agreement being whittled away under the federal securities laws by federal courts and the Securities and Exchange Commission, no one can safely predict the outer boundaries of the federal securities laws.

If the federal securities laws continue to expand to such a degree as to cover violations of article 2.41, state actions under article 2.41 will yield to federal suits. The availability of a longer statute of limitation, nation-wide service of process, exemption from state security for expense requirements, and other significant procedural advantages under the federal securities laws heavily favor an antifraud suit under some provision such as rule 10b-5 over any state action. In addition, the common law elements of fraud have been less stringently enforced or eliminated in 10b-5 suits, so that the burden of proof may be easier to carry than under a state suit. Moreover, the defenses of reliance on financial statements or an opinion of counsel, or dissenting in writing to the transaction, may not be available under rule 10b-5, but merely constitute mitigating circumstances. Furthermore, under these laws the choice of defendants is anything but narrow; not only would liability befall the director assenting to a wrongful repurchase transaction, and possibly the participating shareholder, but the accountant and attorney may also be drawn into the litigation.

In and of itself, the dual coverage of article 2.41 and the federal antifraud provisions should not be upsetting. In fact, under normal circumstances the overlap would be beneficial to most parties involved in a repurchase transaction as full disclosure of material facts would be a mere added prerequisite to such a transaction. But court construction of statutes like article 2.03 which have moved a number of apparently legitimate transactions into violations of article 2.41 should be of concern if these transactions are also automatically deemed breaches of the antifraud provisions of the federal securities laws. A violation of article 2.41 is a far cry from a violation of the federal securities laws, which provide not only civil liability but criminal liability, larger recoveries, and injunctions from future dealings in securities. Thus, the par-

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56 A. Bromberg, supra note 1, at 3.
57 SEC v. National Student Marketing Corp., Civil No. 225-72 (D.D.C., filed Feb. 3, 1972). In this action the Securities and Exchange Commission has charged, among other things, that certain attorneys were under a duty to notify the Securities and Exchange Commission concerning the misleading nature of financial statements of the attorneys' client.
59 A. Bromberg, supra note 1, at 15.
60 For example, see SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971), where it was found that the registration provisions of the Securities Act were violated, but an injunction was denied since the defendants had relied in part on the advice of counsel that the transactions were legal.
61 See note 57 supra. For a discussion of the allegations in this case against the attorneys and accountants involved, see 5 THE REVIEW OF SECURITIES REGULATION 913 (1972).
62 The arsenal of remedies and possible actions against persons violating the federal securities laws is awesome. In addition to statutory provisions for civil and criminal liability and injunctive relief, the Securities and Exchange Commission, pursuant to its rule-making authority, has promulgated additional remedies. For example, rule 10b-5 has become by
Participants in a share repurchase transaction that violated article 2.41 because the surplus requirements of article 2.03 were applied at the time cash left the corporation rather than when the repurchase agreement was executed or a promissory note was exchanged for shares, would face extremely severe sanctions under the federal securities laws. Surely these participants should not pay for the shortcomings of decisions such as *Mountain State* and *Mathews*. This analysis demonstrates the need for eliminating the problems inherent in article 2.03 by new legislation before seemingly legal repurchase transactions which presently violate only state statutes by reason of erroneous decisions are challenged under more harsh federal antifraud provisions such as rule 10b-5.

V. PROPOSED AMENDMENT

To alleviate the problems caused by the imposition of the surplus requirements at the time cash leaves the corporation, amendments to the TBCA are necessary. In the following proposed amendments the italicized portions represent the proposed changes to existing statutes.

Article 2.16 would be amended to provide that:

Neither promissory notes nor the promise of further services shall constitute payment or part payment for the issuance of shares of a corporation.

Article 2.03 (F) would read:

*No purchase or payment for its own shares shall be consummated at the time when there are reasonable grounds for believing that the corporation is insolvent, or would be rendered insolvent by such purchase or payment or when, after such purchase or payment, the fair market value of its total assets will be less than the total amount of its debts.*

A new paragraph H would be added to article 2.03:

(1) *As used in this Article, the term "purchase" means the taking by sale, discount, negotiation, mortgage, pledge, lien, issue or reissue, gift or any other voluntary transaction creating an interest in property.*

(2) *As used in this Article, the term "payment" means the giving of value consisting of:*

(a) *money paid, labor done, or property actually delivered;*

(b) *a binding commitment to deliver cash, perform services, or deliver property at a time certain in the future;*

(c) *a promise or covenant to perform or refrain from performing at a time certain in the future;*

(d) *the collection or compromise of indebtedness owed; or*

(e) *generally, any consideration sufficient to support a simple contract.*

far the most popular provision of the federal securities laws under which to seek almost any type of relief. See generally A. Bromberg, supra note 1. Another example is SEC Rules of Practice 2(e), 17 C.F.R. § 201.2(e) (1972), which provides that any attorney, accountant or other professional expert who has been permanently enjoined on the basis of a securities law violation may be ordered to show cause why he should not be censored or temporarily or permanently disqualified from practicing before the SEC.
To support the amendments and show clearly their intent, the comment should provide that:

The addition of the language "or payment for" to paragraph F of Article 2.03 of the TBCA is intended to insure that the insolvency limitation is applied to both date of purchase and date of payment while the surplus restrictions are applied only at date of purchase. Paragraph H of Article 2.03 of the TBCA specifies the times the surplus restrictions and the insolvency provision apply. Both the surplus requirements and insolvency tests must be satisfied on the date of "purchase," while only the insolvency tests, and not the surplus requirement, must be met on the date of "payment." The addition to paragraph F and new paragraph H make a repurchase of shares contract final on the date value leaves the corporation. Thereby, a selling shareholder, who receives value in the form of a promissory note or debenture, or otherwise delays receipt of cash for shares sold to the corporation, succeeds to the status of a general creditor of the corporation in that he does not assume the risk that the corporation will have insufficient surplus in the future to cover the price remaining to be paid on his instrument of indebtedness; he only assumes the risk that the corporation will not become bankrupt.

Under the proposed amendments, creditor protection would be as well served when a corporation purchases its own shares as when a corporation distributed dividends or assets in partial liquidation. These three transactions were originally intended to be treated similarly, as each involves a distribution of assets available to pay creditors. Over-generous courts have upset the scheme in favor of creditors by disregarding the intent of the drafters of the surplus statutes, relying on outdated precedent effectively overruled by passage of modern business corporation acts and refusing to consider the consequences that spring from their decisions. This state of confusion has existed too long and must be eliminated by legislation similar to that proposed.

VI. PLANNING PENDING CHANGE

There is no dearth of reasons why the surplus requirements of article 2.03 should apply only on the date of purchase and not when money leaves the corporation as payment for the shares, why a repurchase contract should be final on the date shares are surrendered and value leaves the corporation, why decisions such as Robinson should be distinguished, and why decisions such as Mountain State and Mathews should be overruled. While waiting for these changes, the corporation cannot disregard the variety of legitimate business reasons and circumstances which prompt it to purchase its own shares, just as it cannot give up the leverage when a corporation defers expending cash for repurchased shares. Thus, pending amendment to the TBCA or change in most courts' attitudes, it is necessary to plan around Robinson, Mountain State, and Mathews.

The success of some efforts to avoid the fortuitous application of the surplus requirements depends to a large extent on the jurisdiction. For example, in the Fifth Circuit the exchange of cash and corporate properties for shares, followed
a few hours later by the corporation repurchasing the properties for notes secured by assets of the corporation, has been labelled a subterfuge. In *United States v. General Geophysical Co.*, counsel carefully and specifically planned to avoid the holding of *Robinson*, but not all of the steps of counsel's plan were carried out and documented. Therefore, the court held that the form of the transaction merely tried to disguise the substance of an exchange of a promissory note for shares, which under *Robinson* required application of the surplus requirements on the date cash left the corporation to pay the note.

On the other hand, in Minnesota, a transaction in which promissory notes secured by chattel mortgages were issued in exchange for repurchased shares was final on the date the notes were issued. In that case the form of the contract was decisive. Probably a cash repurchase followed by a loan-back will work in Texas if (1) there is no prior agreement to loan-back the purchase price, (2) there is a sufficient break in time to divorce the purchase from the loan-back, and (3) the cash is actually delivered or the check representing the cash has time to clear the bank before the loan-back.

A planning device that should work, but which failed to clear the surplus requirements hurdle the one time it was challenged, is the use of a dummy corporation as a nominee purchaser of the shares. In *Kleinberg v. Schwartz*, the dummy corporation had no assets, and funds representing the purchase price were deposited by the original corporation directly in the account of the selling shareholder without passing through the dummy. Again, the plan failed because prescribed steps were not carried out. If a subsidiary or affiliate corporation purchases the shares for a promissory note, the surplus requirements can be forgotten. Subsequently, the parent can merge the subsidiary or affiliate into itself if it is imperative that the purchased shares be retired.

For the corporation that desires to repurchase some of its own shares for other than cash or tangible assets, these other suggestions may be helpful:

1. If a promissory note is used as the purchase price, it should be negotiable and secured by mortgages on tangible assets. Repurchased shares should not collateralize the note.

2. Repurchased shares should be forthwith cancelled or otherwise disposed of.

3. When possible, shareholder approval should be obtained.

4. Existing and future creditors should be made cognizant of the transaction.

5. Contractual obligations to pay for shares in the future should be

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63 296 F.2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1962).
64 Tracy v. Perkins-Tracy Printing Co., 278 Minn. 159, 153 N.W.2d 241 (1967).
66 See text accompanying note 34 supra.
67 If repurchased shares are cancelled, some weight must be given under Tex. Bus. Corp. Act Ann. art. 2.03 (E) (1956) to the argument that the surplus requirement is absolved upon cancellation of such shares.
68 In a publicly held corporation, the cost of solicitation of proxies may be prohibitive. However, in the close corporation, the consent of shareholders will, at the minimum, eliminate a class of possible plaintiffs.
evidenced by a promissory note rather than left as a mere contractual liability.

6. A corporate promissory note received by a shareholder in exchange for shares should be discounted as soon as possible or otherwise put into the flow of commerce.

7. An operating subsidiary or affiliate of the corporation should be the nominee purchaser if possible, but a mere shell or dummy corporation could be fatal.

8. Buy-sell arrangements funded with life insurance should be between shareholders, not between shareholders and the corporation.