



1968

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Recommended Citation

Carlos L. Israels, *Limitations on the Corporate Purchase of Its Own Shares*, 22 Sw L.J. 755 (1968)
<https://scholar.smu.edu/smulr/vol22/iss5/4>

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LIMITATIONS ON THE CORPORATE PURCHASE OF ITS OWN SHARES

by

Carlos L. Israels*

FEW American corporation lawyers today would express any doubt that a corporation has the power to purchase and thereafter retire, or hold in its treasury for eventual resale, shares of its own capital stock. That power, though once the subject of the most stubbornly fought conflict in corporation law,¹ and still denied in England,² is granted today in all American jurisdictions, generally by specific statute.

The questions which arise today concern the propriety of the exercise of the power, in a given set of circumstances, to avoid prejudice to creditors of the corporation or to its shareholders—including those who sell their shares to it as well as those who do not. The questions arise within a framework of limitations on exercise of the power imposed by statute (state, and, more recently, federal), by contract, or by judicial decision (again state, and, more recently, federal). Each such limitation has its sanctions in the form of available injunctive relief or claims for damages assertable against the corporation, its directors, or the shareholders who have sold their shares.

I. STATE LAW

A. Statutory Limitations

The framework of limitation in state law springs generally from statute. To illustrate, we select as typical the ABA Model Business Corporation Act,³ the Delaware General Corporation Law,⁴ the New York Business Corporation Law,⁵ and the Texas Business Corporation Act.⁶

The statutes outline a general—but not a complete—equation to dividend law. The Model, New York and Texas Acts prohibit any purchase of shares, as they prohibit any dividend in cash or property, while the corporation is insolvent (in the equity sense of not being able to meet its debts as they mature in ordinary course) or which would bring about such insolvency.⁷ The Delaware sections⁸ are silent as to insolvency. However, according to Judge Learned Hand, the prohibition against the pur-

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¹ Nussbaum, *Acquisition by a Corporation of Its Own Stock*, 35 COLUM. L. REV. 971, 978 (1935).

² *Trevor v. Whitworth*, 12 App. Cas. 409 (1887), still states the rule.

³ Hereinafter referred to as the Model Act.

⁴ DEL. GEN. CORP. LAW (1967).

⁵ N.Y. BUS. CORP. LAW (McKinney 1963).

⁶ TEX. BUS. CORP. ACT (1955).

⁷ ABA-ALI MODEL BUS. CORP. ACT §§ 5, 40 (1966); N.Y. BUS. CORP. LAW §§ 510, 513 (McKinney 1963); TEX. BUS. CORP. ACT arts. 2.03F, 2.38A (1955).

⁸ DEL. GEN. CORP. LAW §§ 160, 170 (1967).

chase of shares while insolvent is "not based on any legal statute but upon general principles."⁹

New York and Delaware prohibit the purchase of shares (1) except from surplus,¹⁰ or (2) "when . . . capital is impaired" or the transaction would cause such impairment.¹¹ New York prohibits the payment of dividends under similar circumstances,¹² but Delaware has its "nimble dividend" provision, which permits payment out of earnings for the current or the preceding year even though capital be impaired, provided the payment does not reduce net assets below the liquidation preference of any shares which carry such a preference.¹³ Here the equation goes out of balance. The fund available for the nimble dividend is not specified as available for the purchase of shares.¹⁴ Similarly, as to wasting asset corporations both New York and Delaware apparently sanction dividends in excess of conventional surplus, but make no special provision for larger share purchases.¹⁵

Under the Model Act there can be no purchase of shares except from earned surplus. Similarly, no dividend may be paid except from unrestricted earned surplus. However, with the consent of the holders of two-thirds of the voting shares, purchases may be made and dividends paid from capital surplus as well.¹⁶

The Texas pattern is based on the Model Act. Shares may be purchased only from "unrestricted earned surplus available therefor"; but with shareholders' consent (a two-thirds majority of all shares, with each class voting separately—perhaps even if non-voting for any other purpose) the purchase can be made from capital or reduction surplus.¹⁷ Dividends of a Texas corporation are also limited to "unrestricted earned surplus," but with shareholders' consent a "distribution in partial liquidation" may be made from reduction surplus.¹⁸ A wasting asset corporation in Texas may, in addition, pay dividends or make a payment in partial liquidation out of depletion or amortization reserves,¹⁹ but there appears to be no authorization for it to purchase its own shares with funds so derived.

B. Contractual Limitations

Today, probably the most important and effective limitation under state law upon the exercise of the corporate power to purchase its own shares is found in the provisions of the senior securities and debt instruments (loan

⁹ *In re Fecheimer Fishel Co.*, 212 F. 357, 364 (2d Cir.), cert. denied, 234 U.S. 760 (1914). The New York dividend statute then in force (N.Y. STOCK CORP. LAW § 58 (McKinney 1951)) made no reference to insolvency. However, cf. UNIFORM FRAUDULENT CONVEYANCE ACT §§ 4, 5; Bankruptcy Act §§ 67d, 70a, 11 U.S.C. §§ 107, 110 (1964).

¹⁰ N.Y. BUS. CORP. LAW § 513 (McKinney 1963).

¹¹ DEL. GEN. CORP. LAW § 160 (1967).

¹² N.Y. BUS. CORP. LAW § 510 (McKinney 1963).

¹³ DEL. GEN. CORP. LAW § 170 (1967).

¹⁴ *Id.* § 160.

¹⁵ N.Y. BUS. CORP. LAW § 510(b) (McKinney 1963); DEL. GEN. CORP. LAW §§ 160, 170(b) (1967).

¹⁶ ABA-ALI MODEL BUS. CORP. ACT §§ 5, 40, 41 (1966).

¹⁷ TEX. BUS. CORP. ACT arts. 2.03C, 2.03D (1955).

¹⁸ *Id.* arts. 2.38A(1), 2.41A(2); cf. ABA-ALI MODEL BUS. CORP. ACT § 41 (1966).

¹⁹ TEX. BUS. CORP. ACT arts. 2.39A, 2.41A(1) (1955).

agreements or the like) of public corporations. Here the equation to dividend restriction is substantially complete.

The normal pattern is to forbid both payment of any dividend (other than in shares of a junior class) and the purchase or retirement of any shares junior to the security for the benefit of which the restriction is imposed, except from earned surplus in excess of a stated amount or accumulated after a specified date or both. Where the restriction is imposed for the benefit of the holders of indebtedness the penalty will be accrual of the right to premature the debt. Preferred shareholders would presumably be entitled to injunctive relief and perhaps also to recovery of any sums improperly applied (at least from responsible corporate officials if not from the recipients).²⁰

C. Statutory Interpretation

Contracts for the purchase by a corporation of its own shares under specified circumstances (sometimes including the mere passage of time) are not uncommon. Historically these contracts have raised such difficult questions as: (a) "mutuality" or illusory promise (on the theory that at the time the obligation matured the corporation might not have available surplus); (b) contract illegal when made (no surplus), but legal when performable (surplus available); and (c) contract legal when made (surplus available), but illegal when performable (no surplus available).

However, the recent New York and Delaware statutes probably reflect a trend to determine the propriety of enforcing the contract at the time when by its terms it becomes performable and someone seeks to enforce it.²¹ Where a creditor (including a receiver or trustee in bankruptcy of the corporation) is the plaintiff, the statutory rules tend to be strictly enforced. Not so when the plaintiff is a non-selling shareholder.²²

Aside from injunctive relief (often sought in contract cases) there are sanctions in the form of personal liability. Participating directors are personally liable for both the illegal purchase of shares and the payment of an illegal dividend. In New York and Delaware liability is for the full amount paid out.²³ In Texas liability is only for the amount paid in excess of what could have been paid without violating the statute.²⁴ There are some interesting questions in this area. A director who votes for or assents to the illegal act is liable, and one who is present and does not record his dissent is deemed to have "assented."²⁵ But what if the director is absent?

²⁰ See discussion accompanying notes 23-24 *infra*.

²¹ DEL. GEN. CORP. LAW § 160 (1967); N.Y. BUS. CORP. LAW § 513 (McKinney 1963). There appears to be no comparable Texas provision.

²² Cases are collected by G. HORNSTEIN, CORPORATION LAW AND PRACTICE §§ 491-99 (1959), and by R. BAKER & W. CARY, CASES AND MATERIALS ON CORPORATIONS 1401-39 (3d ed. unabridged 1959). Cases involving only the rights of other shareholders include *Winchell v. Plywood Corp.*, 324 Mass. 171, 85 N.E.2d 313 (1949); *Barrett v. W.A. Webster Lumber Co.*, 275 Mass. 302, 175 N.E. 765 (1931); *Gipson v. Bedard*, 173 Minn. 104, 217 N.W. 139 (1927); *Rasmussen v. Roberge*, 194 Wisc. 362, 216 N.W. 481 (1927).

²³ DEL. GEN. CORP. LAW § 174(a) (1967); N.Y. BUS. CORP. LAW § 719(a)(2) (McKinney 1963).

²⁴ TEX. BUS. CORP. ACT art. 2.41A(2) (1955).

²⁵ *Id.* art. 2.41B.

Texas is silent. New York places upon the absentee the burden of recording his dissent "within a reasonable time after learning" of the action.²⁶ Delaware is even more strict. The absentee can exonerate himself only by "causing his dissent to be entered on the books containing the minutes of the proceedings *immediately* after he has *notice* of the same."²⁷

There is a trend also in the modern statutes to exonerate directors who act in good faith reliance on accounting records, financial reports or statements, etc.²⁸ Texas specifies also the written opinion of counsel.²⁹ But what is "good faith"? "Honesty in fact in the conduct or transaction concerned"?³⁰ Can the director merely plead "pure heart, empty head," or is some higher standard of commercial reasonableness applicable?³¹ The shareholders whose shares were illegally purchased likewise may be personally liable. The majority rule imposes no liability on the shareholder who innocently (*i.e.*, without knowledge of the corporation's financial condition) receives an illegal dividend from a solvent corporation.³² Where shares have been purchased and creditors' interests impaired, however, recipient shareholders have been required to respond.³³ Query the rule which absolves a selling shareholder from liability where only the interests of other shareholders are involved. Has there been "unjust enrichment" of the selling shareholder? Has he received a discriminatory (non pro rata) dividend which, in fairness, he should disgorge?³⁴

D. Equitable Grounds

The context under this heading for the most part involves purchases by close corporations to "buy out" a decedent or dissident shareholder, the employee whose connection with the corporation has been severed, or the like. Usually all shareholders consent to, or at least do not protest the transaction, and litigation, if it occurs, is settled at an early stage. The cases which have reached the stage of reported decision have generally involved another element—control of the corporation—which will be or has been affected by the purchase.

All of the courts appear to agree that, as against non-selling shareholders, a corporate purchase made for the primary purpose of changing (or

²⁶ N.Y. BUS. CORP. LAW § 719(b) (McKinney 1963).

²⁷ DEL. GEN. CORP. LAW § 174 (1967) (emphasis added). "Notice" is defined in UNIFORM COMMERCIAL CODE § 1-201(25) as including "reason to know" whereas "learning" seems to require actual knowledge.

²⁸ DEL. GEN. CORP. LAW §§ 141(e), 172 (1967); N.Y. BUS. CORP. LAW § 717 (McKinney 1963); TEX. BUS. CORP. ACT art. 2.41E (1955).

²⁹ TEX. BUS. CORP. ACT art. 2.41D (1955).

³⁰ UNIFORM COMMERCIAL CODE § 1-201(19).

³¹ N.Y. BUS. CORP. LAW § 717 (McKinney 1963) holds directors to a standard including exercise of "that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Cf. PA. STAT. ANN. tit. 15, § 1408 (1967) which ends with the word "circumstances." Are the standards the same? See Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporation Officers and Directors*, 77 YALE L.J. 1078 (1968).

³² The cases are collected in R. BAKER & W. CARY, *supra* note 22, at 1371.

³³ *Crandall v. Lincoln*, 52 Conn. 73 (1884); *Kleinberg v. Schwartz*, 87 N.J. Super. 216, 208 A.2d 803 (S. Ct. 1965); *Uffleman v. Boillin*, 19 Tenn. App. 1, 82 S.W.2d 545 (1935).

³⁴ Cf. *Alliegro v. Pan Am. Bank*, 136 So. 2d 656 (Fla. App. 1962), *aff'd*, 149 So. 2d 45 (Fla. 1963).

preserving) control is improper. Injunctive relief will lie, or management may be held personally accountable.³⁵ However, there are substantial difficulties of proof, and the tendency (particularly where public-issue corporations and directors' liability are involved) is *not* to find improper purpose.³⁶

There is almost no state court authority as to whether non-selling shareholders are in some way entitled to "equality of opportunity" to sell. Such a right is implied in one New Jersey case and in one Pennsylvania case,³⁷ and it seems to be the official position of the New York Stock Exchange that there should be some such right.³⁸ However, the only other state court decision I have found is one in Delaware, which (as perhaps might be expected) denies the right.³⁹ There are probably at least two reasons for the paucity of state decisional law in this area. The first is the failure of state statutes generally to require any form of notification, or even post-purchase disclosure, to non-selling shareholders.⁴⁰ The other is the growing tendency—because the transaction by hypothesis involves a "purchase or sale" of securities, and almost invariably involves the use of "means or instruments of transportation or communication in interstate commerce or the mails"—to seek relief in the federal courts under the Securities Exchange Act of 1934 and SEC Rule 10b-5 under that Act.⁴¹

II. FEDERAL LAW

A. Rule 10b-5

Corporate purchase of its own shares has come within the purview of federal law only since the adoption by the Securities and Exchange Commission in 1943 of its Rule 10b-5 under the Securities Exchange Act of 1934. The text of the Rule is as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state

³⁵ See *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (S. Ct. 1962); *Andersen v. Albert & J.M. Anderson Mfg. Co.*, 325 Mass. 343, 90 N.E.2d 541 (1950); *Vulcanized Rubber & Plastics Co. v. Shekter*, 400 Pa. 405, 162 A.2d 400 (1960); *Gilchrist v. Highfield*, 140 Wis. 476, 123 N.W. 102 (1909).

³⁶ Even in *Gilchrist v. Highfield*, 140 Wis. 476, 123 N.W. 102 (1909), the majority reached this result; *and see* *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (S. Ct. 1964); *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960). I have criticized these Delaware decisions on substantive grounds in two earlier articles, *Israels, Are Corporate Powers Still Held in Trust?*, 64 COLUM. L. REV. 1446 (1964); *Israels, Corporate Purchase of Its Own Shares—Are There New Overtones?*, 50 CORN. L.Q. 620 (1965).

³⁷ *Gen. Inv. Co. v. American Hide & Leather Co.*, 98 N.J. Eq. 326, 129 A. 244 (Ct. App. 1925); *Reifsnnyder v. Pittsburgh Outdoor Advertising Co.*, 396 Pa. 320, 152 A.2d 894 (1959).

³⁸ N.Y.S.E. COMPANY MANUAL, at A-179 (1963); N.Y.S.E. LISTING AGREEMENT § I (1968).

³⁹ *Martin v. American Potash & Chem. Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (S. Ct. 1952).

⁴⁰ See *Kennedy, Transaction by a Corporation in Its Own Shares*, 19 BUS. LAW. 319, 333 (1964). The one exception is N.Y. BUS. CORP. LAW § 515(d) (McKinney 1963) which does require disclosure when reacquired shares are cancelled. However the required report is limited in scope and content and is not likely to be genuinely informative.

⁴¹ 15 U.S.C. § 78a (1964); 17 C.F.R. § 240.10b-5 (1968). The quoted phrase appears in many sections of the federal securities acts. Its function, of course, is to state the basis of congressional competence to regulate.

a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴³

The Rule was adopted primarily to provide protection for the defrauded seller of securities, as distinct from the defrauded buyer for whom the Securities Act of 1933 already provided a protective network⁴⁴ and a number of the important proceedings initiated by the Securities and Exchange Commission under the Rule have dealt with corporate purchases of their own shares. Indeed, the first proceeding brought under the Rule was *Ward La France Truck Corp.*,⁴⁵ which required a corporation engaged in a program of purchasing its own shares to disclose recent earnings figures and pending negotiations for sale of control of the company at prices substantially above the market in which the purchases were being made. More recently the Commission's investigative powers and the Rule have been brought to bear administratively against two other issuers engaged in large open market purchases of their own shares. *SEC v. Georgia Pacific Lumber Co.*⁴⁶ involved large open market purchases of shares, through trustees for an employee pension plan, at a time when the company was engaged in acquisitions in which the number of its shares deliverable could be dependent on market price. The result was a consent decree limiting future purchases to fifteen per cent of average daily and ten per cent of weekly stock exchange trading volume. No opening bid is permitted and only one broker can be used at a time. *Genesco, Inc.*⁴⁷ involved a similar pattern without the feature of the acquisition program. There future purchases were limited by agreement to twenty per cent of average daily trading volume and fifteen per cent of weekly volume. The company may bid only the previous closing price on either a one hundred share block or fifty per cent of the opening block traded, whichever is higher.⁴⁸ Thus, in a public issue corporation context the Securities and Exchange Commission has sought by direct action to impose conditions which will afford all stockholders substantial equality of opportunity to sell whenever an issuer embarks upon a substantial program of purchase of its own shares.⁴⁹

Equally important is the broad field of private litigation based upon Rule 10b-5. Since *J.I. Case Co. v. Borak*⁴⁹ sustained an implied federal cause of action for breach of the SEC's proxy rules, it generally has been

⁴³ See generally A. BROMBERG, *SECURITIES LAW: FRAUD—S.E.C. RULE 10b-5* (1967), reviewed by this author in 77 *YALE L.J.* 1585 (1968).

⁴⁴ The story was interestingly told by the draftsman of the Rule, at a conference on codification of the federal securities laws held in the fall of 1966. An edited transcript appears in 22 *BUS. LAW.* 793 (1967). See *id.* at 922 (Freeman).

⁴⁵ 13 *S.E.C.* 373 (1963).

⁴⁶ *CCH FED. SEC. L. REP.* ¶ 91,690 (1966).

⁴⁷ *Id.* ¶ 77,354 (May 10, 1966).

⁴⁸ For comment on the *Georgia Pacific* and *Genesco* cases, see Baker, *Purchase by a Corporation of Its Own Shares for Employee Benefit Plans*, 22 *BUS. LAW.* 439 (1967).

⁴⁹ The same principle (though the purchases were made not by the corporation but by informed "insiders") is implicit in the Commission's proceeding against *Texas Gulf Sulphur Co.*, recently decided in the Second Circuit. *SEC v. Texas Gulf Sulphur Co.*, *CCH FED. SEC. L. REP.* ¶ 92,251 (2d Cir. 1968).

⁵⁰ 377 *U.S.* 426 (1964).

conceded that if and when the question reaches the Supreme Court it will sustain the existence of such a remedy under Rule 10b-5.⁵⁰

That such a cause of action may be asserted in the context of corporate purchase of its own shares is no longer open to argument.⁵¹ The more recent cases which make the remedy (at least in the form of injunctive relief) available to the *potential* as distinct from the actual buyer or seller only emphasize the point.⁵² Most recently the Court of Appeals for the Second Circuit⁵³ upheld a complaint on behalf of shareholders claiming against their issuer which published for the benefit of its security holders data which it "knew or should have known" was misleading.⁵⁴ Similarly, *Surovitz v. Hilton Hotels Corp.*, decided in the Seventh Circuit, found no substantive difficulty with a complaint based on corporate purchase of its own shares without disclosure of material information (*e.g.*, recent figures and the fact that insiders were proposing to "bail out" by tendering shares along with the public at prices the insiders knew to be unjustified).⁵⁵

These cases clearly indicate that the Rule is a potent weapon against corporate purchase of its own shares to three classes of plaintiffs: (1) the selling shareholder as against the corporation which deliberately or negligently misstates or conceals material facts; (2) the non-selling shareholder on the same state of facts or where he has been denied the opportunity to sell—a *fortiori* where insiders have taken advantage of that opportunity; and (3) the corporation (directly or at the instance of shareholders suing derivatively) against "insiders" who misapply corporate funds in purchase programs for their own benefit, *e.g.*, for maintenance of control.⁵⁶

The thrust of the judicial opinions often focuses on what information, misstated or wholly or partially undisclosed, is a "material" fact as that term is used in clause 2 of SEC Rule 10b-5. Judicial definitions are many and varied, but all tend toward the same concept: A fact is "material" if it would be likely to affect the investment judgment of a reasonable man, *i.e.*, his decision whether or not to buy or to sell as the case may be.⁵⁷ Often the matter can be fairly judged only from the standpoint of a particular defendant.

⁵⁰ Professor Bromberg's book, *supra* note 42, is an encyclopedia of the law.

⁵¹ See generally Note, *Corporate Stock Repurchases Under the Federal Securities Laws*, 66 COLUM. L. REV. 1292 (1966).

⁵² *E.g.*, *Mutual Shares Corp. v. Genesco Inc.*, 384 F.2d 540 (2d Cir. 1967); *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967); *Puharich v. Borders Elec. Co.*, CCH FED. SEC. L. REP. ¶ 92,141 (S.D.N.Y. 1968). And see A. BROMBERG, *supra* note 42, § 6.3.

⁵³ Since *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964), probably considered a somewhat "conservative" court in its interpretations of the Rule.

⁵⁴ *Heit v. Weitzen*, CCH FED. SEC. L. REP. ¶ 92,279 (2d Cir. 1968).

⁵⁵ 342 F.2d 596 (7th Cir. 1965), *rev'd on other grounds*, 383 U.S. 363 (1966).

⁵⁶ *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964), denied a remedy under the Rule in such a case; but subsequent decisions even in the Second Circuit do not seem in accord. See *Carliner v. Fair Lanes, Inc.*, 244 F. Supp. 25 (D. Md. 1965); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965). The injunction cases (*e.g.*, *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967)) are important here too. If, as in *Hoover v. Allen*, *supra*, no premium over market was paid, is there no "corporate injury" and thus no remedy? One commentator suggests that the directors could be liable for the total amount paid out, thus equating their position to what it would have been had they bought for themselves. Note, *Corporate Stock Repurchases Under the Federal Securities Laws*, 66 COLUM. L. REV. 1296, 1314 (1966).

⁵⁷ See, *e.g.*, *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); A. BROMBERG, *supra* note 42, § 8.3.

The recent *Texas Gulf Sulphur* case⁵⁸ illustrates the point. Information which both the majority and the dissenting judges seemed to agree was not sufficiently "hard" to have required disclosure to the market generally and which in the corporate interest should not have been so disclosed, was nevertheless deemed by the individual defendants important enough to motivate their purchases of shares. Thus, the majority held that a "material fact" had been concealed and Rule 10b-5 violated.

In our specific context—corporate purchase of its own shares—it seems that, in addition to adequate and generally available information as to the financial condition and current operations of the issuer, at least the following items of information are prima facie material: (a) the identity of the issuer as purchaser; (b) the purpose of the purchase; (c) the size and scope of any purchase program; (d) the methods to be employed in carrying it out; and (e) the intentions of "insiders"—at least officers, directors and controlling shareholders—regarding the sale or retention of their own shares. In general a pattern of requiring disclosure (including these and other items peculiar to the facts of the specific case) appears to be developing.

B. Recent Legislation: A New Chapter?

Significant amendments to the Securities Exchange Act of 1934 were adopted in 1964. Under those amendments the requirement of registration with the Securities and Exchange Commission under that Act was broadened so that today it covers not only issuers having securities listed on a national securities exchange but also any issuer having a minimum of \$1,000,000 of assets and an outstanding issue of equity securities held of record by 500 or more persons.⁵⁹ At the same time the reporting requirements of section 16(a)⁶⁰ and liability for short-swing profits in securities transactions under section 16(b)⁶¹ were expanded to cover officers, directors and ten per cent shareholders of the so-called "12(g) companies" (issuers with outstanding securities traded only over-the-counter but which by reason of size and number of shareholders of record were required to register with the Commission under the Act).

On July 29, 1968, an additional important amendment to the 1934 Act became effective. This enactment, the Williams Bill,⁶² amends sections 13 and 14 of the Act,⁶³ adding new subsections 13(d) and 13(e) and 14(d), 14(e), and 14(f).⁶⁴ Section 13 deals generally with reports by issuers of securities registered under section 12. Section 14 deals with solicitation of proxies from the holders of such securities. The new section 13(d)(1) now requires reporting to the Securities and Exchange Com-

⁵⁸ SEC v. *Texas Gulf Sulphur Co.*, CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir. 1968).

⁵⁹ These amendments are embodied in a new § 12(g), 15 U.S.C. § 78j(g) (1964).

⁶⁰ 15 U.S.C. § 78p(a) (1964).

⁶¹ *Id.* § 78p(b).

⁶² The bill was so called because of its sponsorship by Senator Williams of New Jersey. The bill was S. 310 in the 90th Congress. As enacted, it became Pub. L. No. 90-439, 82 Stat. 454 (1968).

⁶³ 15 U.S.C. §§ 78n, 78o (1964).

⁶⁴ Codified as *id.* §§ 78n(d), 78n(e), 78o(d), 78o(f).

mission by any person who becomes, directly or indirectly, a ten per cent holder of an issue of equity securities registered under section 12. Sections 14(d) and 14(e) deal with so-called "tender offers" and solicitations in defense against such offers. Where a change of control of the board is projected, section 14(f) requires disclosure about those persons proposed to be elected or designated to the board "otherwise than at a meeting of security holders." The disclosure is effected by a filing with the Commission and transmission to security holders of "information substantially equivalent" to what would be required in a proxy statement for an annual meeting.

Tucked in the middle (and clearly an integral part of the regulatory scheme) is new section 13(e) which deals specifically with corporate purchases of their own shares. It reads:

(1) It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940, to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold.

(2) For the purpose of this subsection, a purchase by or for the issuer, or any person controlling, controlled by, or under the common control with the issuer, or a purchase subject to control of the issuer or any such person, shall be deemed to be a purchase by the issuer.

Thus, in effect, Congress has given us a checklist of presumptively "material" information to be disclosed, and has left to the Securities and Exchange Commission the task of filling out the picture by rule. The Commission acted promptly. By its Securities Exchange Act Release No. 8370 (July 30, 1968), it adopted certain temporary rules under the new law. However, only Rule 13e-1⁶⁵ is relevant, and it applies only in a very narrow context. Once there is an outstanding tender offer by a person other than the issuer, the latter may not purchase *any* of its securities (not only those specifically affected by the offer) without first having (a) filed with the Commission and (b) furnished to its security holders either currently or within the past six months a statement covering: (1) the title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the pur-

⁶⁵ Amended in immaterial respects by Securities Exchange Act Release No. 8392 (Aug. 30, 1968).

chase is to be made; (2) the purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer, or otherwise disposed of, and indicating such disposition; and (3) the source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto.

It is anticipated that in due course the Commission will propose for comment, and eventually adopt, broader and more detailed rules under sections 13(e)(1) and 13(e)(2). At this writing one can only speculate as to what areas will be covered. At the outset it will be noted that the statute clearly indicates what direction the thrust must take because it requires that the Rules "define acts and practices which are fraudulent, deceptive and manipulative, and . . . prescribe means reasonably designed to prevent such acts and practices." It has been suggested (in my view probably correctly) that this statute does not give the Commission any more power than it already had under section 10b of the 1934 Act, and that the entire area could have been regulated under Rule 10b-5. The cases cited above would seem to bear this out. On the other hand, civil litigation under the Rule usually operates retrospectively, applying sanctions as to past purchases. Operation in prospect—*e.g.*, to restrain or to regulate contemplated purchases—might well call for a new Commission Rule. The statute appears intended to fill that gap and the quoted language probably does it fully as comprehensively as does the text of Rule 10b-5 from which it is derived.⁶⁶ One peculiarly interesting facet is that section 13(e)(2) equates, for regulatory purposes, purchases by controlling persons (or persons controlled by or under common control with the issuer) with those made by the issuer itself. Presumably, this is a direct outgrowth of the *Georgia Pacific* and *Genesco* cases, where the purchases were made not by the issuer but by trustees who were in effect instruments of the issuer.⁶⁷ The concept of "manipulative" practice clearly includes not only activities which might result in deception of a prospective seller of securities to the company or of one who might determine not to sell in response either to a private solicitation or a tender offer. It is also clearly intended to include practices which might in one way or another disturb an orderly market. Indeed, the limitations on the quantity and manner of trading imposed in *Georgia Pacific* and *Genesco*⁶⁸ look more in this direction than they do to the interests of any specific selling or non-selling shareholder.

I have indicated above some items of material information which should be made available to shareholders of any corporation which engages in a substantial program of purchase of its own shares. In my view, disclosure

⁶⁶ See text accompanying note 42 *supra*.

⁶⁷ See Baker, *Purchase by a Corporation of Its Own Shares for Employee Benefit Plans*, 22 BUS. LAW. 439 (1967).

⁶⁸ See text accompanying notes 45, 46 *supra*.

should be required where such a program is to be carried out over a period of time in the open market or by a public invitation for tenders either of a specified number of shares at a stated price or of a sufficient number of shares to exhaust a specific fund from which purchases are to be made at the lowest tendered price.⁶⁹ Certainly the Commission should not (and presumably will not) attempt by Rule to regulate the possible casual or occasional corporate purchase of its own shares provided that such purchase is made at arm's length, in open market, and not beyond a minimal percentage of the shares outstanding. The *Georgia Pacific* and *Genesco* cases suggest minimal percentages, below which (absent undisclosed material information) purchases might be safely made and merely reported to security holders annually or otherwise in due course. On the other hand, I would suggest that corporations subject to the Rules be required to give their shareholders adequate advance notice of any contemplated program under which any number of shares above the minimum are intended to be purchased. Such advanced notification should be achieved by a filing with the Commission and by advice transmitted to security holders either in an annual or interim report, or by a special mailing, stating the intended scope of the program, its duration, the manner in which it is to be implemented and whether or not to the knowledge of the company any officer, director or ten per cent shareholder proposes to sell. The price also should be specified, at least in relation to market. Conceivably the Rules might require some form of undertaking that the corporation knows of no material fact not disclosed in the specific communication or otherwise generally available to shareholders,⁷⁰ disclosure of which would be necessary in order to make the statements not misleading in the light of the circumstances under which they are made.

Where purchase from a private person or persons is proposed, perhaps regulation should be a bit more stringent. For example, it might require advance notification by filing and communication to security holders if either (1) the amount is above a stated minimum (e.g., more than two per cent of the outstanding securities of the same class), or (2) if the proposed price is above market. Query the extent to which advance notification should be required as to purchases being made by a controlling person for his own account under a program in which he does not directly or indirectly act as an instrument of the corporation.

As should be obvious, my view is that once a corporation determines to purchase its own shares all shareholders are entitled to some form of "equality of opportunity" to sell their shares or to refuse to sell them with the fullest benefit of advance notification and adequate disclosure of all material facts. No well-advised corporation will undertake a purchase program unless by an objective standard (typically availability of shares

⁶⁹ Resort to this sort of technique rather than reliance on private or open market purchase has been increasingly common in recent years. Often use has been made of what has been termed a "reverse prospectus" in order to be sure that adequate information is made available. See Zilber, *Corporate Tender Offers for Their Own Stock: Some Legal and Financial Considerations*, 33 U. CINC. L. REV. 315 (1964).

⁷⁰ E.g., because of inclusion in previous annual reports, public statements and the like.

substantially below conservatively computed book or market value) it appears to be in the corporate interest to do so. Where a private purchase is proposed—certainly where the seller is an “insider”—even greater caution is called for. Does the transaction arguably present an opportunity to market an otherwise unmarketable block of shares? If that is so (or in a half a dozen other imaginable contingencies), is not a tender offer procedure rather than a private or even an open market purchase called for? A scheme of regulation such as appears possible under the new statute would go far, I suggest, to protect legitimate shareholder interests and, should the Commission adopt rules requiring advance notification, would encourage litigation seeking injunctive relief prospectively rather than damages in retrospect. Clearly there is a developing body of federal corporation law in many areas—and SEC Rule 10b-5 has been a major contributing cause.⁷¹ The new statute brings the field of corporate purchase of its own shares well within the ambit. If the securities involved are not registered under section 12 of the Securities Exchange Act of 1934, the federal courts will remain free to grant appropriate relief under Rule 10b-5. If and when litigation arises in a state court, one may expect in the long run some conformity to federal standards of managerial fiduciary responsibility.⁷²

⁷¹ See, e.g., Fleischer, *Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146 (1965). And see A. BROMBERG, *supra* note 42, *passim*.

⁷² See, e.g., *Diamond v. Oreamuno*, 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1968).