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STUDENT NOTES

ACQUISITION BY A WEST VIRGINIA CORPORATION OF ITS OWN STOCK

The vexatious problem of the acquisition by a corporation of its own stock has been raised anew in West Virginia, through the enactment a year ago of the Capital Reduction Amendment\(^1\) to the Corporation Code. It is thus important to examine carefully the so-called common law restrictions in this regard. Apparently a corporation may purchase its own stock without express authority in the absence of statutory prohibitions, provided it acts in good faith and without prejudice to creditors or shareholders.\(^2\) The right to purchase should be confined, however, within strict limits in order to safeguard the rights of creditors and preserve to them the security of the minimum financial reserve as measured by the capital stock,\(^3\) i.e., the amount in money or property actually paid in by the stockholders of the corporation. No problem arises where the corporation acquires treasury stock\(^4\) by donation or when the corporation has no debts and shareholders all agree to the purchase; but when stock is bought out of capital no equivalent is furnished to creditors.\(^5\)

Upon the acquisition of such shares the corporation may treat the stock as a live asset and hold it for resale,\(^6\) but in that case it is at most merely a potential asset,\(^7\) for in the event of dissolution or insolvency resort to it by creditors would be of no avail. If the corporation treats the stock as cancelled,\(^8\) an unauthorized reduc-

\(^4\) "Treasury Stock" is stock that has been issued and later reacquired by the same company. See 5 FLETCHER, CYC. CORP. § 3421; Kemp v. Levin-ger, 162 Va. 665, 174 S. E. 820 (1934).
\(^7\) Borg v. International Silver Co., 11 F. (2d) 147, 150 (1925).
\(^8\) Glenn, op. cit. supra n. 2, at 635, 636. "Treasury Stock" is not stock at all, it cannot be voted, nor can it receive dividends or be considered in determining a dividend rate. German v. Farmers' Tobacco Warehouse Co., 280 Ky. 249, 94 S. W. (2d) 82 (1935); see note (1926) 44 A. L. R. 11.
tion of capital is effected, although where the statute provides a method of capital reduction, it would seem at least that between the state and corporation there could be no capital reduction unless there was compliance with the statute. Hence, whether the corporation retains its treasury stock or retires it, the result is an actual reduction of capital which is in reality a fraud or deceit to creditors because they are entitled to have the capital remain in the business.

In order not to imperil the creditors’ security and thus preclude attack by or in behalf of creditors, various courts and writers have laid down rules to guide the corporation in purchasing its stock. Some require that such purchase must not impair capital, others that the purchase must be out of surplus, and a few that the purchase must be out of excess of assets over liabilities; one or two merely hold that purchase must not render the corporation insolvent. Since the danger to the creditors’ security is

[Notes and Citations]

10 W. Va. Rev. Code (1931) c. 31, art. 1, §§ 13 and 14: Allows payment out of excess of value of property over new capital created by the reduction, but provides for reaching assets so distributed. Creditors are subjected, however, to the disadvantages of tracing dispersed monies. See also supra n. 1.
11 For example, a corporation might desire to reduce its capital when it has more cash than its decreasing business requires. See DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 591; also Note (1926) 44 A. L. R. 11.
12 Borg v. International Silver Co., supra n. 7.
13 As to effect on rights of shareholders, see Levy, Purchase by a Corporation of Its Own Stock (1930) 15 Minn. L. Rev. 1; General Investment Co. v. American Hide and Leather Co., 97 N. J. Eq. 214, 129 Atl. 244, 44 A. L. R. 60 (1925).
14 MORAVETZ, PRIVATE CORPORATIONS (2d ed. 1886) § 112.
18 Marshall v. Fredericksburg Lumber Co., 162 Va. 136, 173 S. E. 553 (1934); see also 5 FLETCHER, CYC. CORP. § 3470; see also note (1926) 44 A. L. R. 53, 18.
19 In re International Radiator Co., 5 Boyce 261, 92 Atl. 255 (1914); Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N. Y. 206, 163 N. E. 735, 66 A. L. R. 1179 (1928).
20 Wormser, supra n. 2; Robinson v. Wangeman, supra n. 5.
22 A fortiori, if purchase renders corporation insolvent, or is by a corporation already insolvent, it is a pure fraud on creditors; Coleman v. Tepel, supra n. 17; Davies v. Montana Auto Finance Corp., 86 Mont. 500, 254 Pac. 267 (1930); Scriggins v. Thomas Dalby Co., supra n. 6; Schwemer v. Fry, 212 Wis. 88, 249 N. W. 62 (1933).
substantially increased by the possibility of shrinkage in the book value of assets, or a fall in market prices affecting inventory values, it would seem that the corporation in purchasing its stock should be limited to payment out of earned surplus, i.e., net profits, and be made in good faith and be limited to a reasonable amount of stock. Such distribution would have no more effect than payment by the corporation of a dividend. Thus both stockholders and creditors would be protected, and the corporation is prevented from trafficking in its own shares for the purpose of creating an artificial market value, shifting control of the corporation, eliminating a militant minority of shareholders by voting treasury stock, or giving a preference in the distribution of the corporate assets.

In a recent case the court found as fact that the purchase price paid by the company depleted its assets to the injury of creditors. Under the circumstances the court reached a desirable result in holding defendant liable to the extent of the creditors' unsatisfied claims.

West Virginia, in permitting a corporation to purchase its stock, has perceived the danger to creditors, and to an extent has provided for their protection by the code provisions requiring that such purchase must not impair capital, i.e., be made out of surplus, except in the purchase or redemption of preferred stock, where the statute merely requires that the remaining assets of the corporation be sufficient to pay the corporate debts.

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23 As distinguished from surplus created by mere bookkeeping revaluation, or paid in surplus. See DeWing, op. cit. supra n. 11, at 579 et seq.
25 Nussbaum, Acquisition by a Corporation of its Own Stock, 35 Col. L. Rev. 971, 1004 (1935).
26 See W. Va. Rev. Code (1931) c. 31, art. 1, § 39, providing a corporation cannot vote shares so held.
28 The Gibbon Company purchased a large block of its capital stock from defendant, a principal stockholder, officer and director in the company. Although the corporation was not rendered insolvent, its capital was seriously impaired. Held, void, on ground that (1) it was ultra vires for a New Jersey corporation to purchase its own stock, and (2) because the capital of the company was seriously impaired by depletion of its assets to the injury of creditors. Gibbon v. Hill, 79 F. (2d) 288 (1935).
29 Robinson v. Wangeman, supra n. 5; Wigginton v. Auburn Wagon Co., supra n. 15.
30 W. Va. Rev. Code (1931) c. 31, art. 1, § 39 and Revisers' Note that purchase must be made from surplus.
of the corporation provide for the redemption of preferred stock, creditors and other shareholders can be said to have had notice; but when the preferred stock is issued without the redemption privilege, the corporation in repurchasing it might pay out capital with impunity so long as it complied with the statute. Apparently the legislature felt that the statute provided adequate protection for creditors, and at the same time increased the saleability of preferred stock. Assuming, however, that the remaining assets will bring their full book value, the statute goes rather far in permitting a stock purchase to reduce the fundamental "capital" of the corporation.

In the case of a no par stock corporation, where the stock is sold for such consideration as directors deem advisable, no restriction or limitation having been put in the charter, there is no figure ascertainable from the statute or articles of incorporation representing the true capital of the corporation, except the stated minimum of $1,000.00 which the statute requires as capital. Since the statute provides for repurchase of no par shares from

33 Thompson v. Shepherd, 205 N. C. 310, 165 S. E. 796 (1932).
34 W. VA. REV. CODE (1931) c. 31, art. 1, § 40; see also Olmstead v. Vance & Jones Co., 196 Ill. 236, 63 N. E. 634 (1902) (a secret contract between corporation and certain stockholders to repurchase their stock in two years is void as to creditors of the corporation).
35 Since the statute would permit the assets to be reduced to within one dollar of the liabilities, it would place corporation upon the brink of insolvency, at least under the bankruptcy test; and a slight decrease in market value of remaining assets would render corporation insolvent, thus effecting a fraud as to creditors; see supra n. 22. Query as to whether bankruptcy solvency or equitable solvency?
36 Apparently W. VA. REV. CODE (1931) c. 31, art. 1, § 40 would not affect rights of creditors who became such prior to its enactment; [see W. VA. REV. CODE (1931) c. 31, art. 1, § 8] but it is likely that the problem would not arise today since the statute was enacted in 1931.
37 W. VA. REV. CODE (1931) c. 31, art. 1, §§ 27, 28, 29 empowers board of directors to issue no par stock of any class, subject to any restrictions, and for such consideration as charter may authorize; but if no consideration is named in the charter then for such consideration as directors may deem advisable. W. VA. REV. CODE (1931) c. 31, art. 1, § 6 in case of no par stock requires incorporators to state a minimum capital of one thousand dollars and the number of shares to be issued, which is required for the purpose of fixing the corporation’s license tax.
38 W. VA. REV. CODE (1931) c. 31, art. 1, § 6.
39 Id. at § 39.
surplus, it would seem that all consideration received for no par stock should be capitalized rather than to allocate all or a part of such consideration to paid-in surplus. Otherwise a corporation might flagrantly abuse its powers by distributing paid-in surplus to favored shareholders in the course of reacquiring its stock.

The foregoing discussion presents a picture of the situation in this state prior to enactment of the new Capital Reduction provision. The purpose of this recent enactment was to provide a speedy and safe method for capital reduction, while dispensing somewhat with formalities heretofore required. So far as the purchase of shares for retirement may be involved, a corporation is now authorized to effect such acquisition,

"... either pro rata from all holders of shares of that class of stock or by purchasing such shares from time to time in the open market or at private sale."

Curiously enough, however, no specific limit is set by the new provision as to the extent to which the capital reduction may be carried. In other words, a corporation with a capital of several hundred thousand dollars might presumably purchase shares out of its assets without restrictions other than the sane judgment and good sense of its associates. Certainly, the reduction should not be carried below the statutory requirement of the minimum capital of one thousand dollars, with which a corporation must begin business. On the other hand, so far as the new statute is concerned, the corporation need retain only sufficient assets to pay its existing debts, provided proper notice by publication be given. Thus, under the guise of reducing its capital, a corporation may now freely buy in its shares in West Virginia, so long as the formalities be observed. The danger then is not to existing creditors, — for the law of fraudulent conveyances adequately protects them: it is, rather, the possibility of defrauding subsequent creditors who may not know of an unusual capital reduction. Particularly would this be true where a corporation transacts its business largely outside of West Virginia.

A statute limiting all stock purchases to payments out of earned surplus, (i.e., net profits) would, except in the instance of authorized capital reduction, afford adequate protection to all

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40 Supra n. 1.
41 Vogtman v. Merchants' Mort. & Credit Co., 178 Atl. 99 (Del. 1935).
creditors and shareholders and place distribution of assets in this manner on a parity with dividend disbursements. In the case of an authorized capital reduction by a West Virginia corporation neither having any office nor conducting any business within the state, it would seem that there should be an additional publication of notice not only at the place where the corporation’s principal office is located, but also at its principal place of business and in every state in which it does business.