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Redemption of Stock under the Model Business Corporations Act and the Virginia Stock Corporation Act

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I. INTRODUCTION

The Model Business Corporation Act (hereinafter the "Model Act") has been in existence for more than twenty-five years, and has served as the paradigm for the revised corporation statutes of approximately twenty-five states, including Virginia.[1] Despite its age, certain of its provisions have been infrequently applied and interpreted in judicial opinions. One such set of provisions is that dealing with a corporation's right to redeem shares of its stock. The

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1. The Committee on Business Corporations of the Section of Corporation, Banking and Business Law of the American Bar Association prepared a first draft of a model business corporation act in 1946 patterned on the Illinois Business Corporation Act then in effect. This draft was largely superceded by a 1950 version which may be regarded as the basis of the present MODEL ACT. The MODEL ACT has been frequently revised; extensive revisions were published in 1953, 1959 and 1969. The text of the 1950 version is contained in 6 BUS. LAW. 1-112 (1950). For comments on the early drafts see Garrett, *History, Purpose and Summary of the Model Business Corporation Act,* 6 BUS. LAW. 1 (1950); Garrett, *The Model Business Corporation Act,* 4 BAYLOR L. REV. 412 (1952); Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?,* 50 NW. U. L. REV. 1 (1955); Jennings, *The Role of the States in Corporate Regulation and Investor Protection,* 23 LAW AND CONTEMP. PROB. 193, 197 (1958). For a critique of methodology employed in the drafting of the MODEL ACT, see Eisenberg, *The Model Business Corporation Act and the Model Business Corporation Act Annotated,* 29 BUS. LAW. 1407 (1974).

Unless the content otherwise requires, references throughout this article to the "MODEL ACT" are to the 1969 version of the Model Business Corporation Act as contained in MODEL BUSINESS CORPORATION ACT ANNOTATED (2d ed. 1969) (including the 1973 and 1977 Supplements) [hereinafter cited as MODEL ACT].

As of 1977, twenty-five states and the District of Columbia have revised their corporation law statutes to substantially incorporate the MODEL ACT. In addition, it has been used to a great extent in the drafting of the corporation law statutes of eleven other states. MODEL ACT § 1, Comment (1969 & Supp. 1973, 1977).

Virginia's stock corporation statute (VA. CODE ANN. §§ 13.1-1 to 200 (Repl. Vol. 1978)) was extensively revised in 1956 to conform to the MODEL ACT. Virginia was one of the earlier states to have adopted the MODEL ACT. *See* Emerson, *Vital Weaknesses in the New Virginia Stock Corporation Law and the Model Act,* 42 VA. L. REV. 489 (1956) [hereinafter cited as Emerson]; and Gibson, *The Virginia Corporation Law of 1956,* 42 VA. L. REV. 445 & 603 (1957) [hereinafter cited as *Virginia Corporation Law*].

purpose of this article is to analyze the Model Act's provisions regarding the redemption of shares;[2] and to review, in contrast thereto, the relevant provisions of the Virginia stock corporation act.

II. Model Act Approach

A. *Statutory Approach*

Three sections of the Model Act state the substantive rules regarding the redemption of shares and the consequences thereof. Sections 6 and 66 contain the substantive provisions with respect to redemption and section 67 states the consequences of a share redemption to the corporation's capital structure.[3]

Section 6, which states the special advantage to be accorded a redemption of shares, provides in part that:

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2. Case law with respect to redemption will be discussed insofar as it may explicate the statutory language of the Model Act. However, an extensive survey of the case law or a discussion of those issues regarding redemption not found in the statute will not be attempted. For an extensive exposition of the case law regarding redemption of shares, see Buxbaum, *Preferred Stock-Law and Draftsmanship*, 42 Calif. L. Rev. 243 (1954) [hereinafter cited as Buxbaum]; Dodd, *Purchase and Redemption by a Corporation of its own Shares—The Substantive Law*, 89 U. Pa. L. Rev. 697 (1941) [hereinafter cited as Dodd]; Jones, *Redeemable Corporate Securities*, 5 S. Calif. L. Rev. 83 (1931) [hereinafter cited as Jones].

3. Additional provisions with respect to the creation of the redemption privilege are contained in §§ 15 and 16 of the Model Act.

The Committee on Corporate Laws (Section on Corporation, Banking and Business Law) of the American Bar Association recently adopted drastic revisions to the financial provisions of the Model Act (35 Bus. Law. — (April 1980); 34 Bus. Law. 1867 (1979)) which would eliminate the concept of redemption of shares.

Briefly, the revision defines a new term "distribution" which includes all transfers of money or property by a corporation to its shareholders by dividend, share repurchase or otherwise (§ 2(i)). A corporation is authorized to make distributions unless after giving effect thereto either it would be unable to pay its debts as they become due in the usual course of business or its assets would be less than its liabilities plus any liquidation preferences (§ 45). If, as part of the distribution, the corporation acquires shares of its stock, such shares shall constitute authorized, but unissued, shares (§ 6).

The accounting definitions in the current § 2 are eliminated as are the concepts of par value, stated capital, treasury shares, redemption and cancellation of shares. This article does not analyze these revisions. It does illustrate, however, some of the difficulties and uncertainties in the present provisions which, of course, are eliminated by the revisions. It thus places the revisions in a better perspective. Also, it may be some years before the states consider the revisions. This article may be of assistance in interpreting the existing provisions during that period.

> A corporation shall have the right to purchase . . . its own shares, but purchases of its own shares . . . shall be made only to the extent of unreserved and unrestricted earned surplus available therefor, and, if the articles of incorporation so permit or with the affirmative vote of the holders of a majority of all shares entitled to vote thereon, to the extent of unreserved and unrestricted capital surplus available therefor.
>
> To the extent that earned surplus or capital 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.
>
> Notwithstanding the foregoing limitation, a corporation may purchase or otherwise acquire its own shares for the purpose of:
>
> (d) [e]ffecting, subject to the other provisions of this Act, the retirement of its redeemable shares by redemption or by purchase at not to exceed the redemption price.
>
> 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.[4]

Section 66 imposes two significant limitations on this special advantage and provides that:

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4. MODEL ACT § 6(d). The complete text of § 6 is as follows:

> 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, whether direct or indirect, shall be made only to the extent of unreserved and unrestricted earned surplus available therefor, and, if the articles of incorporation so permit or with the affirmative vote of the holders of a majority of all shares entitled to vote thereon, to the extent of unreserved and unrestricted capital surplus available therefor.
>
> To the extent that earned surplus or capital 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.
>
> Notwithstanding the foregoing limitation, a corporation may purchase or otherwise acquire its own shares for the purpose of:
>
> (a) Eliminating fractional shares.
>
> (b) Collecting or compromising indebtedness to the corporation.
>
> (c) Paying dissenting shareholders entitled to payment for their shares under the provisions of this Act.
>
> (d) Effecting, subject to the other provisions of this Act, the retirement of its redeemable shares by redemption or by purchase at not to exceed the redemption price.
>
> 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.

> No redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such redemption or purchase would render it insolvent, or which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

The consequence to the corporation's capital structure of a share redemption or a repurchase of redeemable shares as stated in section 67 is as follows:

> When redeemable shares of a corporation are redeemed or purchased by the corporation, the redemption or purchase shall effect a cancellation of such shares, and a statement of cancellation shall be filed as provided in this section. Thereupon such shares shall be restored to the status of authorized but unissued shares, unless the articles of incorporation provide that such shares when redeemed or purchased shall not be reissued, in which case the filing of the statement of cancellation shall constitute an amendment to the articles of incorporation and shall reduce the number of shares of the class so cancelled which the corporation is authorized to issue by the number of shares so cancelled.
>
> The statement of cancellation shall be executed in duplicate by the corporation by its president or a vice president and by its secretary or an assistant secretary, and verified by one of the officers signing such statement. . . .
>
> Upon the filing of such statement of cancellation, the stated capital of the corporation shall be deemed to be reduced by the part of the stated capital which was, at the time of such cancellation represented by the shares so cancelled.[5]

The thrust of the general share repurchase provisions of section 6 is to allow a corporation to repurchase shares of its stock only from those sources of funds available under the Model Act for the distribution of a cash or property dividend.[6] This consistency is appro-

5. MODEL ACT § 67.

6. MODEL ACT § 45(a) (earned surplus) and § 46 (capital surplus). Section 45 contains an alternative subsection (a) authorizing a dividend from earned surplus or net earnings of the current and immediately preceding fiscal year (the nimble dividend provision). Section 6, however, does not authorize share redemptions or repurchases from net earnings. Section 45(d) separately authorizes the declaration and payment of a stock dividend from "surplus." As such, this source is likewise not available for share redemptions or repurchases. However,

priate since a cash or property dividend and a share repurchase have the same economic effect on the corporation. Assets are transferred from the corporation to the shareholders. The potential harm to creditors is the same in either transaction; assets otherwise available to satisfy the claims of creditors are transferred to the shareholders.[7]

The Model Act's approach to dividend distributions, and thus to share repurchases generally, is extremely flexible. Section 45(a) of the Model Act follows a dividend distribution theory which authorizes payment of a cash or property dividend from the corporation's earnings, either the current earnings or, more typically, the past earnings as reflected in its earned surplus.[8] Under this approach

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use of §§ 45(a) and 46 collectively would exhaust "surplus." This is so since § 2(k) defines "surplus" as "the excess of net assets [assets minus liabilities, (§ 2(i))] of a corporation over stated capital," and § 2(m) defines "capital surplus" as "the entire surplus of a corporation other than its earned surplus." Section 45 contains special conditions and requirements for the declaration and payment of a stock dividend, such as the capitalization of surplus in amount equal to the par or stated value of the shares issued (§ 45(d)(1) and (2)); and an authorization of the payment either by express provision in the articles of incorporation or affirmative vote or written consent of a majority of the shares of the class in which payment is to be made (MODEL ACT § 45(e)).

7. Of course the potential for discrimination and the relative unfairness among the shareholders is greater in a share repurchase than a dividend declaration. A dividend declaration will apply to all shares of the same class; whereas in share repurchases the potential of favoring some shareholder by purchasing some or all of their shares and not the shares of others is very real. The courts in some recent cases hold the board of directors to high fiduciary standards in connection with share repurchases, particularly in the closely held corporation context. Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 328 N.E.2d 505 (1975); Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

The MODEL ACT'S consistent approach to dividends and share repurchases is not unique. Virtually all state corporation statutes impose limitations on the sources of funds for share repurchases at least as stringent as those imposed on dividend payments. For a discussion of the various dividend restrictions see 7 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING, §§ 147.01-.05 (1979) [hereinafter cited as Z. CAVITCH]. For a concise analysis of the tension between creditors and shareholders regarding asset distributions see B. MANNING, LEGAL CAPITAL 1-15 (1977) [hereinafter cited as B. MANNING].

8. Section 45(a) of the MODEL ACT provides:

> The board of directors of a corporation may, from time to time, declare and the corporation may pay dividends in cash, property, or its own shares, except when the corporation is insolvent or when the payment thereof would render the corporation insolvent or when the declaration or payment thereof would be contrary to any restriction contained in the articles of incorporation, subject to the following provisions:
>
> (a) Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation, except as otherwise provided in this section.
>
> [Alternative] (a) Dividends may be declared and paid in cash or property only out

the shareholders' contribution to the corporation, paid in exchange for the corporation's shares, is permanently dedicated to the corporation. The shareholders' contribution serves as a cushion for the benefit of creditors; and cannot be returned to the shareholders until liquidation, after all creditors have been fully paid.[9] However, the immediately following section, section 46, authorizes, subject to specific requirements, the payment of dividends from capital surplus.[10] Such a dividend, in contrast to the theory of section 45, rep-

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of the unreserved and unrestricted earned surplus of the corporation, or out of the unreserved and unrestricted net earnings of the current fiscal year and the next preceding fiscal year taken as a single period, except as otherwise provided in this section.

Earned Surplus is defined in § 2(1) of the MODEL ACT as:

the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.

9. Assume a corporation has outstanding 100 shares common stock, par value $1 per share, issue price $10 per share, net earnings for its third year of operation of $1,000, and a balance sheet at the end of its third year as follows:

Assets	Liabilities	
$15,000	$12,000	
	100	Stated Capital
	900	Paid in Surplus
	1,000	
	2,000	Earned Surplus
$15,000	$15,000	

Section 45(a) would authorize a dividend of $2,000 or $1,000 depending on whether straight § 45(a) or alternative § 45(a) was adopted.

In either instance, however, the amount of the total shareholder contribution, reflected in stated capital and paid in surplus is not available for dividends. Instead, that amount remains permanently committed to the enterprise. Dividends are paid from the earnings on the shareholder investment. Earned surplus, by definition, cannot be created by a transfer of funds from stated capital or capital surplus. However, earned surplus can be reduced by a transfer of funds from earned surplus to capital surplus (MODEL ACT § 70), and a deficit in earned surplus can be reduced or eliminated through an application of capital surplus (MODEL ACT §§ 2(1), 70).

10. Section 46 authorizes a dividend payment from capital surplus, if the conditions set

forth therein are met. It provides in part that:

> The board of directors of a corporation may, from time to time, distribute to its shareholders out of capital surplus of the corporation a portion of its assets, in cash or property, subject to the following provisions:
>
> (a) No such distribution shall be made at a time when the corporation is insolvent or when such distribution would render the corporation insolvent.
>
> (b) No such distribution shall be made unless the articles of incorporation so provide or such distribution is authorized by the affirmative vote of the holders of a majority of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of the articles of incorporation of the corporation.
>
> (c) No such distribution shall be made to the holders of any class of shares unless all cumulative dividends accrued on all preferred or special classes of shares entitled to preferential dividends shall have been fully paid.
>
> (d) No such distribution shall be made to the holders of any class of shares which would reduce the remaining net assets of the corporation below the aggregate preferential amount payable in event of involuntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of liquidation.
>
> (e) Each such distribution, when made, shall be identified as a distribution from capital surplus and the amount per share disclosed to the shareholders receiving the same concurrently with the distribution thereof.
>
> The board of directors of a corporation may also, from time to time, distribute to the holders of its outstanding shares having a cumulative preferential right to receive dividends, in discharge of their cumulative dividend rights, dividends payable in cash out of the capital surplus of the corporation, if at the time the corporation has no earned surplus and is not insolvent and would not thereby be rendered insolvent. Each such distribution when made, shall be identified as a payment of cumulative dividends out of capital surplus.

The text of § 46 authorizes a corporation to "distribute" to its shareholders out of capital surplus. It does not explicitly authorize, except in the last paragraph regarding cumulative preferred dividends, the payment of dividends from capital surplus. However, the Comment to the Section indicates that dividend distributions are contemplated. "The flexibility provided by this section permits a corporation, with certain safeguards, to pay 'dividends' out of any surplus, whether earned or capital." MODEL ACT § 46, Comment. Subsection (b) contains the requirement that the shareholders consent to the distribution to them of a portion of the principal represented by their shares either because the articles of incorporation authorize the distribution, and shareholders are charged with knowledge of the articles, or because the distribution has been specifically approved by them.

In the example stated in note 9 *supra,* stated capital is $100; surplus is $2,900. Section 46 would authorize the payment of a dividend of $900, the amount of the "paid in surplus." This term is not defined in the MODEL ACT. But it is apparent from the definitions of "surplus," "capital surplus" and "earned surplus" that paid in surplus must be part of capital surplus. It is surplus, but it is not earned surplus; hence, it must be capital surplus.

A dividend payment of $900 from capital surplus represents a return to the shareholders of a substantial portion of the $1,000 shareholder investment. Moreover, it reduces the cushion available to the creditors from the $1,000, which would have been available if a dividend were declared only from earned surplus, to $100. Although § 46(a) requires shareholder consent, the creditors, for whose benefit the cushion exists, need not even be notified of the distribution.

In the example, the maximum amount of dividend payment under straight §§ 45(a) and 46(a) would be $2,900; $2,000 from earned surplus and $900 from capital surplus. There is no prohibition against declaring and paying a dividend from both sources. Also, it appears that the two sections are independent of one another. A dividend can be paid from capital sur-

resents a return to the shareholders during the corporation's life of a portion of their invested capital. It also diminishes the dollar amount of the cushion available to creditors. The section authorizes a return only of that portion of their investment allocated to capital surplus; that portion allocated to stated capital remains permanently dedicated to the corporation until liquidation.[11]

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plus even though earned surplus exists. B. MANNING, *supra* note 7, at 74. Accounting convention does not favor such a practice, however. DAVIDSON & WEIL, HANDBOOK OF MODERN ACCOUNTING 29-11 (2d ed. 1977). The last paragraph of § 46 expressly authorizes a dividend payment on cumulative preferred shares from capital surplus; but it conditions this right on the absence of earned surplus. An explanation for this limitation may be that the right to use capital surplus as a source for cumulative dividend payments is available to all corporations, unfettered by the safeguards of subsections (a) through (d).

The MODEL ACT's dividend payment provisions have been widely commented on. *See, e.g.*, Gibson, *Surplus, So What?*, 17 BUS. LAW. 476 (1962); Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357 (1957) [hereinafter cited as Hackney]; Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435 (1952) [hereinafter cited as Seward].

For an excellent explanation of the theories supporting, and the operation of, the various general types of dividend statutes, *see* B. MANNING, *supra* note 7, at 59-83, 109-63.

The Virginia dividend statute appears not to allow a single dividend declaration from both earned surplus and capital surplus sources. VA. CODE ANN. § 13.1-43 provides in part that "[d]ividends . . . may be declared and paid . . . only out of the unreserved and unrestricted earned surplus of the corporation *or* out of capital surplus, howsoever arising. . . ." (emphasis added). *See* Emerson, *supra* note 1, at 523; *Virginia Corporation Law, supra* note 1, at 464.

11. This highlights the critical distinction between high par and low par stock. Section 2(j) of the MODEL ACT defines "stated capital" to include the sum of "(1) the par value of all shares of the corporation having a par value that have been issued. . . ." The excess of the issue price over par value is paid in surlus.

In the example stated in note 9 *supra*, if the par value and the issue price for the shares were $10, the balance sheet would have read:

Assets	Liabilities	
$15,000	$12,000	
	1,000	Stated Capital
	0	Paid in Surplus
	1,000	
	2,000	Earned Surplus
$15,000	$15,000	

The maximum dividend under § 45(a) would be $2,000 (the amount of the earned surplus). If this were paid, assets would be reduced to $13,000, and earned surplus would be reduced to zero. No dividend could be paid under § 46 since there is no capital surplus. The total amount of the shareholder's contribution would be permanently committed to the corporation and available to creditors.

Thus, by denominating the shares as $1 par in the articles of incorporation instead of $10

Against this rather summary and elementary exposition of the Model Act's provisions regarding share repurchases generally, the advantage provided to a corporation by a redemption of a portion of its outstanding shares is apparent. If a corporation is merely repurchasing its shares, it is limited to earned or capital surplus as the source of funds from which the reacquisition can be accomplished. On the other hand, if a corporation redeems, or repurchases its redeemable shares, section 6 authorizes, by implication, the invasion of a corporation's stated capital to effect the transaction.[12]

Despite this advantage which the Model Act appears to give a corporation when redeeming, instead of repurchasing, its shares,[13]

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par, an additional fund of $900 is created which is available for dividend payment. In no event, however, is the amount attributed to stated capital available as a source of dividend payment.

It is important to recognize that share repurchases under the general authorization contained in the first two paragraphs of MODEL ACT, § 6 would be treated in the same manner as the dividend declaration authorized in §§ 45 and 46 with the proviso contained in the second paragraph that earned or capital surplus would be restricted, and thus unavailable for future dividend payments or share repurchases, so long as the purchased shares are held as treasury stock.

Share repurchases and dividends from capital surplus are similar inasmuch as in both instances a sum of money may be paid to the shareholder which, from the perspective of both the corporation's capital structure and accounting concepts, represents a portion of all the shareholder investment. However, depending on the price the share repurchase may represent a return to the shareholder of all, or less than all, of his individual investment in the shares. Moreover, in a share repurchase the shareholder receives this sum in exchange for his shares; whereas in the dividend context the shareholder's position becomes more leveraged. He has an expectation of dividends in the future supported by less of an investment. And he has lost no control, even though his investment has decreased.

12. Literally, § 6 does not expressly authorize a corporation to invade stated capital to effect a redemption; it simply removes the prohibition against so doing. *See* text accompanying note 42 *infra*.

13. An instance in which this advantage may be useful is as follows: Assume a corporation has a capital structure consisting of 100 preferred shares par value and issue price $100, liquidation preference and redemption price $110; and 100 common shares par value $1, issue price $10.

Assets	Liabilities	
$25,000	$12,000	
	10,000	Stated Capital—Preferred
	0	Paid in Surplus—Preferred
	100	Stated Capital—Common
	900	Paid in Surplus—Common
	11,000	
	2,000	Earned Surplus
$25,000	$25,000	

there is surprisingly little analysis in judicial opinions of which transactions constitute redemptions and which are merely repurchases. Occasionally share repurchases are referred to as redemptions.[14]

It wishes to reacquire 50 of its preferred shares at a price of $110 per share, the redemption price. This price represents a return to the shareholder of his $100 investment plus a $10 premium. The transaction would require an expenditure of $5,500 from various legal sources for share reacquisition. Under the general rules of §§ 6, 45(a) and 46 of the MODEL ACT, the corporation would be unable to complete the transaction. Earned surplus in only $2,000 and capital surplus $900; these generally are the only two available sources. The bulk of the shareholders' investment is permanently dedicated to the corporation in the stated capital account. However, if the reacquisition were deemed to be a redemption of shares, it could be accomplished. Part of the stated capital ($5,500) would be used to make the redemption, thereby advantaging the shareholders whose shares are redeemed to the possible detriment of creditors. The remaining preferred shareholders are not disadvantaged since the net assets available after the redemption at least equal the involuntary dissolution preference of the remaining preferred shares (MODEL ACT § 66). The common shares, however, would be disadvantaged because the stated capital represented by the common would also be available for payment to the remaining preferred shares on redemption or liquidation.

A source of funds to effect the reacquisition could be created by other means. For example, the articles of incorporation could be amended to reduce the par value of the preferred shares from $100 to $10. If this were done, the stated capital would become $1,000, and a surplus fund referred to as a "reduction surplus" of $9,000 would be created. This "reduction surplus" by definition is part of "capital surplus" and would be available, as provided in § 46, as a source from which the reacquisition could be accomplished. Section 56 of the MODEL ACT authorizes a reduction in capital, or in this context, the creation of a surplus, to be accomplished through an amendment to the articles of incorporation to reduce the par value of the shares. An advantage in effecting the transaction in this manner is that the separate limitations of §§ 66 and 67 would be inapplicable. An amendment to the articles of incorporation would require the affirmative vote of all the shareholders and of the preferred shareholders voting as a class. MODEL ACT §§ 59 and 60.

14. *See* Cunningham v. Jaffe, 251 F. Supp. 143 (D.S.C. 1966); a bankruptcy proceeding in which defendant shareholders caused a corporation to reacquire their shares while capital was impaired. The court called the transaction a stock redemption. *Id.* at 148. In Kohn v. Birmingham Realty Co., 352 So. 2d 834 (Ala. 1977), plaintiff sued to enjoin the holding of a special shareholders meeting to approve a redemption of shares. (The Alabama statute referred to, ALA. CODE § 21(57) (1958) (current version at § 10-2-164 (1975)), was comparable to the general provisions of MODEL ACT § 6, regarding share repurchases.) *See also* King Mach. Co. v. Caporaso, 2 N.J. Super. 230, 63 A.2d 270 (1949).

In some opinions the facts of the transaction are interpreted to define whether the transaction is a redemption or a repurchase. *See* Glens Falls Ins. Co. v. National Bd. of Fire Underwriters Bldg. Corp., 63 Misc. 2d 989, 314 N.Y.S.2d 80 (1970), *aff'd* 318 N.Y.S.2d 915 (1971); *In re* West Waterway Lumber Co., 59 Wash. 2d 310, 367 P.2d 807 (1962).

The confusion in terminology is caused in part by §§ 302 and 317 of the Internal Revenue Code. Section 317(b) provides in part that "stock shall be treated as redeemed by a corporation if the corporation *acquires its stock from a* shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired or held as treasury stock" (emphasis added). Section 302 treats a redemption (as defined in § 317(b)) as an exchange of property if the requirements of § 302(b) are met (giving rise to capital gains tax treatment).

B. *Statutory Ambiguities*

1. Lack of a Definition

One of the significant contributions of the Model Act to corporate law in general is its fairly extensive and explicit definitional section, particularly regarding accounting matters.[15] Unfortunately, under the Model Act, there are two critical, but undefined terms: "redemption" and "redeemable shares."[16] Redeemable shares would appear to be shares which are subject to redemption. Hence a definition of "redemption" also defines "redeemable shares." Redeemable shares, however, can be reacquired in transactions constituting either a redemption or a purchase.

A redemption is merely one species of reacquisition transactions. Any transaction whereby a corporation reacquires its shares is a contract, express or implied. The shareholder transfers his shares to the corporation, and in exchange the corporation pays some valuable consideration to the shareholder. The corporate law consequences of a share repurchase differ considerably from the consequences of a share redemption. However, the distinction between a redemption and a repurchase, or more precisely between redemption contractual provisions and repurchase contractual provisions, is simply a matter of form, not substance. The same shares, held by the same shareholder can be either the subject of a redemption

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Otherwise, § 302(d) treats the redemption price as a distribution of property which is considered (i) as a dividend (giving rise to ordinary income) to the extent of earning and profits, (ii) as a return of capital (reducing basis) to the extent the redemption price exceeds earnings and profits and (iii) as capital gain to the extent the redemption price is not fully absorbed in (i) and (ii). Thus, for income tax purposes, the term "redemption" can apply to any reacquisition by a corporation of its shares. *See* Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Central & S. W. Corp. v. Brown, 249 F. Supp. 787 (D. Del. 1965). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 9.01-.65 (4th ed. 1979)

An additional source of confusion is the use of a term "stock redemption agreement" in the closely held corporation context to refer to an agreement in which the corporation is either obligated, or has the option of reacquiring shares upon the happening of stated events. *See* Hamilton Nat'l Bank of Knoxville v. Graning Paint Co., 59 Tenn. App. 37, 436 S.W.2d 883 (1968). 2 F. H. O'NEAL, CLOSE CORPORATIONS §§ 7.10 & 10.38(B) (2d ed. 1971 & Cum. Supp. 1979) [hereinafter cited as F. H. O'NEAL].

15. Section 2 is the definitional section of the MODEL ACT. For an analysis of these definitions see Garrett, *Capital and Surplus Under the New Corporation Statutes,* 23 LAW AND CONTEMP. PROB. 239 (1958); Hackney, *supra* note 10, *passim;* Seward, *supra* note 10, *passim.*

16. Sections 6, 66 and 67 apply to the "redemption" of shares and, with certain qualifications, to the "purchase of redeemable shares."

provision, with its attendant advantages, or a repurchase agreement, depending on the language and placement of the contractual commitments.

A redemption provision can take one of two general forms. It is either mandatory, obligating the corporation to redeem the shares upon a fixed date or upon the occurrence of a specified event,[17] or it is optional, giving to the corporation the option to redeem, or to the shareholder the option of requiring the redemption of the shares, upon a fixed date or the occurrence of a specified event.[18] In either of the general forms the redemption provision is a right or an obligation of the shares themselves. It applies to all shares of a designated group or class and is part of what is loosely referred to as the "shareholder contract." The identity of the holder of the shares is irrelevant; there is no agreement between the corporation and the shareholder personally. The corporation and the holder of the shares are bound by the redemption provision because they are contained in the shareholder contract.[19] In contrast, a repurchase agreement is a specific, personal contract between the corporation and a particular shareholder, obligating the corporation to repurchase the shares, or giving the corporation or the shareholder the option of having the shares repurchased.[20] From the shareholder's perspective, the effect is the same; in either a redemption or a repurchase transaction, he transfers shares and receives consideration.

The essential distinction between the redemption and the repurchase is that in a redemption the contractual commitment inheres in the shares, rather than in an agreement negotiated between the

17. Z. CAVITCH, *supra* note 7, at § 147.05[1]; Dodd, *supra* note 2, at 719; 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5309, 5310 (rev. perm. ed. 1971) [hereinafter cited as W. FLETCHER]; Jones, *supra* note 2, at 91.

18. Z. CAVITCH, *supra* note 7, at § 147.05[1]. Of course after the party in whose favor the option is granted has exercised the option, the provision becomes mandatory on the other party. If the corporation exercises the option to redeem, the shareholder must sell. *See* Borst v. East Coast Shipyards, Inc., 105 N.Y.S.2d 228 (1951).

19. A publicly held issue of preferred stock, subject to redemption, is the best illustration of this contractual anonymity. The shares can be traded over and over. The identity of a holder is not part of the contract. The contract is not personal, but binds anyone holding the shares, since its terms inhere in the shares.

20. A corporate buy-sell agreement can also be non-personal and anonymous. It could bind all persons who may acquire the shares, regardless of whether the corporation's consent to the transfer is required.

corporation and a shareholder.[21]

The form over substance aspect of the distinction is particularly pronounced in the closely held corporation context.[22] A corporation could agree, for example, with a shareholder-employee to repurchase all of his shares on the occurrence of a specified event, such as retirement. This contractual commitment would be subject to the general provision of section 6 of the Model Act limiting the funds available to effect the repurchase to earned or capital surplus. The requirement of section 6 would become implied terms of the contract, even if not expressly referred to therein. If the corporation had inadequate earned or capital surplus, the purchase could not be concluded, despite the contractual provision.[23] Alternatively, if the corporation had issued the shareholder-employee a class of preferred or common stock,[24] redeemable upon the employee's retirement, the corporation could invade stated capital, pursuant to section 6, in an amount necessary to effect the purchase.[25]

The classic view was that redemption provisions, like other rights of certain shares, are part of the shareholder contract. The substance of this vague contract was to be found in a variety of sources: the share certificates, the articles of incorporation, the bylaws and even the resolutions of the board of directors.[26] It was not uncommon for the rights of redemption to be placed only in the share certificates;[27] and they frequently were stated both in the ar-

21. Z. CAVITCH, *supra* note 7 at § 147.05(2); Note, *Redemption of Preferred Shares,* 83 U. PA. L. REV. 888, 889 (1935).

22. For a discussion of redemption provisions in the closely held corporation context see 2 F. H. O'NEAL, *supra* note 14, at § 3.34; Note, *Stock Redemption at the Option of the Shareholder in the Close Corporation,* 48 IOWA L. REV. 986 (1963) [hereinafter cited as *Stock Redemption*].

23. The corporation could create capital surplus through a reduction in capital. *See* note 13, *supra.*

24. *See* text accompanying notes 53-82, *infra,* regarding the possibility of redeemable common shares.

25. The North Carolina statute includes in the list of exceptional transactions for which stated capital can be invaded an agreement between a corporation and an employee providing for the reacquisition of the employee's shares. N.C. GEN. STAT. § 55-52(b)(4).

26. Ericksen v. Winnebago Industries, Inc., 342 F. Supp. 1190 (D. Minn. 1972); Kern v. Chicago & E. Ill. R.R., 6 Ill. App.3d 247, 285 N.E.2d 501 (1972); Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N.E. 383 (1933); Knight v. Shutz, 141 Ohio St. 267, 47 N.E.2d 886 (1943); Schaad v. Hotel Easton Co., 369 Pa. 486, 87 A.2d 227 (1952). *See* 11 W. FLETCHER, *supra* note 17, at § 5284.1.

27. Ericksen v. Winnebago Industries, Inc., 342 F. Supp. 1190 (D. Minn. 1972).

ticles and in the share certificates.[28]

However, today vitually all corporation statutes make reference to the inclusion of redemption provisions in the articles of incorporation.[29] In fact, recent cases refer to the articles of incorporation as the embodiment of the shareholder contract.[30] The ability to redeem is often included, through the state's corporation statute, in the grant of authority to issue shares and to state the relative rights and preference of such shares.

2. Where Must Redemption Provisions Be Contained

Typically the statutes provide that the corporation is authorized by provisions in the articles of incorporation to divide the authorized shares into classes, and to state therein the relative rights and preferences of the various classes. The corporation is then given authority to issue the shares, with such relative rights and preferences. The statutes often do not literally require that redemption rights be contained in the articles of incorporation to be effective. This requirement arises somewhat more obliquely. The corporation is only authorized to issue shares, the rights and preferences of which must be stated in the articles of incorporation. Therefore, by implication the redemption provisions must be contained in the articles of incorporation. Shares, purporting to be redeemable, could not be issued unless reference to the redemption features is made in the articles of incorporation.

The Model Act follows this approach. Section 15 provides in part:

> Each corporation shall have power to create and issue the number of shares stated in its articles of incorporation. Such shares may be divided into one or more classes . . . with such designations, preferences, limitations, and relative rights as shall be stated in the articles of incorporation. The articles of incorporation may limit or deny the voting rights of or provide special voting rights for the shares of

28. United States Radiator Corp. v. State, 208 N.Y. 144, 101 N.E. 783 (1913); Geiger v. American Seeding Mach. Co., 124 Ohio St. 222, 177 N.E. 594 (1931); Knight v. Shutz, 141 Ohio St. 267, 47 N.E.2d 886 (1943); Adams v. United States Distrib. Corp., 184 Va. 134, 34 S.E.2d 244 (1945), *cert. denied*, 327 U.S. 788 (1946).

29. Even under the classic approach the articles of incorporation were usually controlling; and inconsistencies would be resolved in favor of the articles.

30. Shanghai Power Co. v. Delaware Trust Co., 316 A.2d 589 (Del. Ch. 1974).

any class to the extent not inconsistent with the provisions of this Act.

Without limiting the authority herein contained, a corporation, when so provided in its articles of incorporation, may issue shares of preferred or special classes:

(a) Subject to the right of the corporation to redeem any of such shares at the price fixed by the articles of incorporation for the redemption thereof. . . .[31]

The first paragraph of the section has been fairly consistently enacted in the Model Act jurisdictions and is not significantly different from other statutory approaches. However, the provisions in the second paragraph regarding redemption contain two ambiguities, which appear in the enactments in most Model Act jurisdictions but which have not been carried over to the statutes of some other jurisdictions. While the first paragraph provides that the corporation may issue shares with such preferences and relative rights

31. The full text of § 15 entitled "Authorized Shares," is as follows:

Each corporation shall have power to create and issue the number of shares stated in its articles of incorporation. Such shares may be divided into one or more classes, any or all of which classes may consist of shares with par value or shares without par value, with such designations, preferences, limitations, and relative rights as shall be stated in the articles of incorporation. The articles of incorporation may limit or deny the voting rights of or provide special voting rights for the shares of any class to the extent not inconsistent with the provisions of this Act.

Without limiting the authority herein contained, a corporation, when so providing in its articles of incorporation, may issue shares of preferred or special classes:

(a) Subject to the right of the corporation to redeem any of such shares at the price fixed by the articles of incorporation for the redemption thereof.

(b) Entitling the holders thereof to cumulative, non-cumulative or partially cumulative dividends.

(c) Having preference over any other class or classes of shares as to the payment of dividends.

(d) Having preference in the assets of the corporation over any other class or classes of shares upon the voluntary or involuntary liquidation of the corporation.

(e) Convertible into shares of any other class or into shares of any series of the same or any other class, except a class having prior or superior rights and preferences as to dividends or distribution of assets upon liquidation, but shares without par value shall not be converted into shares with par value unless that part of the stated capital of the corporation represented by such shares without par value is, at the time of conversion, at least equal to the aggregate par value of the shares into which the shares without par value are to be converted or the amount of any such deficiency is transferred from surplus to stated capital.

Delaware (DEL. CODE ANN. tit. 8 § 151(a) (Rev. 1974)) and New York (N.Y. BUS. CORP. LAW § 501(a) (McKinney 1963)) are to the same effect. For a statement of other statutory provisions authorizing redemption rights, see Z. CAVITCH, *supra* note 7, at § 147.05[3].

"as shall be stated *in* the articles of incorporation,"[32] the language in the second paragraph regarding redemption is less precise.

The second paragraph states that a corporation, when so provided in its articles of incorporation, may issue preferred or special shares subject to the corporation's right to redeem "at the price fixed *by* the articles of incorporation."[33] The phrase does not read, as do the comparable provisions in some statutes, "at such price . . . and under such conditions as are stated *in* the certificate of incorporation."[34] The language in the Model Act might allow the redemption price and terms to be stated in some other document, such as a shareholder agreement with a reference made to the document in the articles of incorporation.[35] Arguably, since the second paragraph states specifically the conditions upon which a corporation may issue shares of preferred or special classes with redemption rights, it ought to prevail over the first paragraph to the extent of any inconsistency.[36]

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32. MODEL ACT, § 15 (emphasis added).

33. *Id.* (emphasis added).

34. N.Y. BUS. CORP. LAW § 512(a) (McKinney 1963) (emphasis added). *See also* DEL. CODE ANN. tit. 8 § 151(b) (Rev. 1974); GA. CODE ANN. § 22-501 (1977); KAN. STAT. ANN. § 17-6603 (1974); MICH. COMP. LAWS ANN. § 450.363 (1973); N.J. STAT. ANN. § 14A:7-6(1) (West 1969). Virtually all the MODEL ACT jurisdictions have provisions identical in substance, if not in language, to the MODEL ACT. One exception is Montana, MONT. CODE ANN. 35-1-612(3)(d) (1978), which contains no reference to the articles of incorporation.

35. A provision in the articles of incorporation to the effect that "preferred shares shall be redeemed at the price and on the terms contained in a shareholder's agreement dated ____ between ____ and ____ Corporation" would appear to comply with the literal language of § 15.

36. The Comment to § 15 is of no assistance in determining the draftsmen's intent. The specific subsections of the second paragraph of § 15 treat all of the customary preferences and rights of preferred shares, redemption, dividends, liquidation and conversion. However, the phrase "by the articles of incorporation" appears only in subpart (a) dealing with redemption. A fair construction of the language of the remaining subparts, when read in conjunction with the first paragraph of § 15 and the introductory portion of the second paragraph, is that the specific rights and designations regarding dividends, liquidation and conversion must be contained in the articles. This conclusion in turn supports the argument that all of the subparts should be construed alike, and thus that redemption rights must be contained in the articles. There would appear to be little purpose served in requiring the dividend, liquidation and conversion rights to be stated in the articles, and then authorizing the redemption rights to be contained in some other document with reference made to it in the articles. Also, it could be argued that the language of the introductory portion of the second paragraph, "when so provided in its articles of incorporation," is intended to control over any inconsistency in subsection (a); and thus, the redemption provisions must be contained in the articles.

With respect to voting rights, the first paragraph of § 15 explicitly states that the articles

The other ambiguity in the second paragraph is that, again unlike many other statutory privisions,[37] no reference is made in section 15 to the terms of the redemption. The possibility thus exists that under the Model Act the terms on which the redemption right may be exercised, including the triggering date or event or the manner of payment, could be contained in some other document, such as a shareholder agreement or the share certificates themselves.

These two ambiguities in section 15 leave open the possibility that there may be some vitality to the older notion of a shareholder contract wherein the terms of the contract are to be found in numerous documents.[38]

These ambiguities in section 15 are carried over into, or are perhaps resolved by, section 16.[39] That section essentially contains two

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of incorporation may limit or deny voting rights to preferred or special classes, to the extent consistent with other provisions of the ACT.

37. N.Y. BUS. CORP. LAW § 512(a) (McKinney 1963) and the other statutes cited in note 35 *supra,* including PA. STAT. ANN. tit. 15 § 603 (Purdon 1967).

38. Such an interpretation is inconsistent with statements in various cases to the effect that the redemption rights must be contained in the articles of incorporation. *See* Ericksen v. Winnebago Indus., Inc.; 342 F. Supp. 1190; Shanghai Power Co. v. Delaware Trust Co., 316 A.2d 589.

39. If the articles of incorporation so provide, the shares of any preferred or special class may be divided into and issued in series. If the shares of any such class are to be issued in series, then each series shall be so designated as to distinguish the shares thereof from the shares of all other series and classes. Any or all of the series of any such class and the variations in the relative rights and preferences as between different series may be fixed and determined *by the articles of incorporation,* but all shares of the same class shall be identical except as to the following relative rights and preferences, as to which there may be variations between different series:

(A) The rate of dividend.

(B) Whether shares may be redeemed and, if so, the redemption price and the terms and conditions of redemption.

(C) The amount payable upon shares in event of voluntary and involuntary liquidation.

(D) Sinking fund provisions, if any, for the redemption or purchase of shares.

(E) The terms and conditions, if any, on which shares may be converted.

(F) Voting rights, if any.

If the articles of incorporation shall expressly vest authority in the board of directors, then, to the extent that the articles of incorporation shall not have established series and fixed and determined the variations in the relative rights and preferences as between series, the board of directors shall have authority to divide any or all of such classes into series and, within the limitations set forth in this section and in the articles of incorporation, fix and determine the relative rights and preferences of the shares of any series so established.

provisions. First, it authorizes the corporation, if so provided in its articles of incorporation, to divide its classes of preferred or special shares into series and to designate differing rights for the various series. Second, it empowers the board of directors, if so authorized by the articles of incorporation, to amend the articles, without shareholder approval, to define the rights of the shares of a theretofore unissued series.

Section 16 can be said to carry over the ambiguities in section 15 since it provides that the variations in relative rights and preferences between series of a class or preferred or special shares "may be fixed and determined *by* the articles of incorporation,"[40] not *in* the articles of incorporation. Moreover, it provides that shares of different series within a given class shall have identical rights and

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In order for the board of directors to establish a series, where authority so to do is contained in the articles of incorporation, the board of directors shall adopt a resolution setting forth the designation of the series and fixing and determining the relative rights and preferences thereof, or so much thereof as shall not be fixed and determined by the articles of incorporation.

Prior to the issue of any shares of a series established by resolution adopted by the board of directors, the corporation shall file in the office of the Secretary of State a statement setting forth:

(a) The name of the corporation.

(b) A copy of the resolution establishing and designating the series, and fixing and determining the relative rights and preferences thereof.

(c) The date of adoption of such resolution.

(d) That such resolution was duly adopted by the board of directors.

Such statement shall be executed in duplicate by the corporation by its president or a vice president and by its secretary or an assistant secretary, and verified by one of the officers signing such statement, and shall be delivered to the Secretary of State. If the Secretary of State finds that such statement conforms to law, he shall, when all franchise taxes and fees have been paid as in this Act prescribed:

(1) Endorse on each of such duplicate originals the word "Filed," and the month, day, and year of the filing thereof.

(2) File one of such duplicate originals in his office.

(3) Return the other duplicate original to the corporation or its representative.

Upon the filing of such statement by the Secretary of State, the resolution establishing and designating the series and fixing and determining the relative rights and preferences thereof shall become effective and shall constitute an amendment of the articles of incorporation.

MODEL ACT § 16 (emphasis added).

40. *Id.* (emphasis added). The phrase "by the articles of incorporation" in this section applies to all of the customary preferred share rights and preferences, dividend, redemption, liquidation, conversion and voting rights. Since the phrase qualifies those rights and preferences which by the terms of § 15 must be contained in the articles of incorporation (the dividend, liquidation, conversion and voting rights), the phrase, arguably, ought not be interpreted differently with respect to redemption rights.

preferences except that the separate series within a class may have different rights and preferences with respect to "the redemption price *and terms and conditions of redemption.*"[41] If there were a class of preferred or special shares undivided into series, section 15 would require that only the redemption price be mentioned, whereas if the class were divided into series, section 16 would require that a statement of the price and terms of redemption for each series within the class be specified in the articles of incorporation. It seems inconsistent to require that the terms and conditions of redemption be stated in the articles of incorporation for each series within a class, under section 16, but not to require the same for the undivided class under section 15. The argument could be made that the terms and conditions of redemption ought to be stated for the whole class. However, the statute does not literally require it.

The second portion of section 16 allows the board of directors to establish the relative rights and preferences of the various series within the classes of preferred or special shares. The board could establish such rights and preferences by adoption of a resolution which would constitute an amendment to the articles of incorporation. If the board determined the price and terms and conditions of redemption of shares in this manner, the redemption rights would be contained *in* the articles of incorporation by amendment.[42] It may be inconsistent that they not be required in the articles of incorporation in its original form.

3. What Kind of Redemption Provisions Are Authorized

Although it is generally accepted that redemption may either be compulsory, or at the option of either the corporation or the shareholder,[43] most statutes do not explicitly authorize shareholder option redeemable shares.[44] The Model Act is one such statute. The

41. MODEL ACT § 16(B) (emphasis added).

42. The procedure allowed by this section, the authorization of blank stock, is a clear exception to the general proposition that amendments to the articles of incorporation require shareholders approval to be effective. MODEL ACT §§ 59-63. It thus provides the corporation with a maximum financing flexibility by eliminating the need to call a special shareholders meeting to approve an amendment setting the terms of the additional series of shares. *See* W. CARY, CASES AND MATERIALS ON CORPORATION 1228 (4th ed. 1969); 11 W. FLETCHER, *supra* note 17, at § 5284.1.

43. *See* note 18, *supra.*

44. Some state statutes specifically allow issuance of shares redeemable at the option of

second paragraph of section 15 specifically authorizes the issuance of shares "subject to the *right of the corporation* to redeem."[45] The statute is silent regarding the issuance of shares redeemable at the option of the shareholder. However, it appears sufficiently clear that such shares could be issued. The introductory phrase to the specific authorization of redeemable shares begins "[w]ithout limiting the authority herein contained."[46] This would appear to allow the issuance of such shares since there is not prohibition against them elsewhere in the Act.[47]

Except in those states specifically prohibiting the issuance of shareholder redeemable shares,[48] there is no strong position taken against such shares.[49] The absence of express authorization of such shares is attributable, perhaps, to the classic notion that redeemable shares are a form of senior security which provide the corporation with the flexibility to replace the capital they represent with

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the shareholder: DEL. CODE ANN. tit. 8, § 157 (Rev. 1974); MD. CORPORATIONS AND ASSOCIATIONS CODE ANN. § 2-105(5) (1974). N.J. STAT. ANN. § 14A:7-6(3) (West 1969) specifically authorizes shares redeemable at the option of the shareholder if authorized in the original certificate of incorporation or by an amendment thereto approved by the unanimous vote of the shareholders. It limits the use of shareholder option redeemable shares, except in an open-end investment company, to corporations in which there are fewer than 25 holders of such shares, excluding officers, directors, employees, and their spouses. The Commissioner's Comment to this section states that it is "desirable to enable careful planning of participants in such essentially 'incorporated partnerships,' and affords a technique superior to the present practice of reliance on 'buy-sell' agreements between shareholders and the corporation." The corporation is authorized to invade stated capital to redeem the shares. N.J. STAT. ANN. § 14A:7-16(3) (West 1969). Other state statutes clearly preclude issuance of shareholder option redeemable shares: GA. CODE ANN. § 22-501 (1977); OHIO REV. CODE ANN. § 1701.23 (Page 1978); 18 OKLA. STAT. ANN. tit. 18 § 1.75(c) (West 1953); S.C. CODE § 33-9-190(c) (1977).

In Westerfield-Bronte Co. v. Burnett, 176 Ky. 188, 195 S.W. 477 (1917) and Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N.E. 383 (1933) shareholder option redemptions were upheld under statutes not expressly authorizing them.

45. MODEL ACT § 15 (emphasis added). Thus, it covers both compulsory redemption and redemption at the option of the corporation.

46. *Id.*

47. The Comment to § 15 supports this conclusion. It states that the variation in the characteristics of shares is limited "in the Model Act, and in most states only by the imagination of the draftsman. . . ." 1 MODEL ACT ANN. 359 (1969). Also the Comment to § 66 states that "[S]tock may be issued . . . with a covenant to redeem either at a fixed date or on a stated contingency or on the demand of the shareholder. . . ." 2 MODEL ACT ANN. 304 (1969). *See Stock Redemption, supra* note 22, at 988.

48. *See* note 44 *supra.*

49. However, *see* Dodd, *supra* note 2, at 722 for a criticism of the practice, especially with respect to redeemable common shares. *See also* 1 F. H. O'NEAL, *supra* note 14, at § 3.34.

less expensive funds whenever it deems this desirable.[50] It would thus be a right which only the corporation should enjoy.[51]

4. Are Common Shares Redeemable

Another uncertainty in the Model Act scheme is whether shares of common stock can be made redeemable. Section 15 provides that a corporation may issue shares of "preferred or special classes" and that such shares may be made redeemable.[52] Section 16 authorizes issuance of "preferred or special classes"[53] in series. It is generally accepted that there are two generic types of shares, preferred and common. By definition a common share is not a preferred share.[54] Under the Model Act scheme, a common share can be redeemable only if it fits within the term "special class."[55] The words "or special classes" can be construed in one of two ways. They either modify or further describe the word "preferred," or they allow the creation of a category of shares which in some way is different from "preferred" shares. Under the former interpretation redeemable common shares would not be authorized because "special" would be included as part of the notion of "preferred," and common shares are distinct from preferred. However, this interpretation is less likely. Since the term "preferred" is generally understood there is no need to further define it through description. To do so would needlessly confuse the definition of the term.[56] If, alter-

50. V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE, 199 (2d ed. 1979); Jones, *supra* note 2, at 87-88.

51. Little attention has been paid to use of the redemption provision in the closely held corporation as a means of increasing the funds available for share reacquisitions. In this context the comment of the New Jersey Commissioners, regarding shareholder option redeemable shares is particularly noteworthy. *See* 2 F. H. O'NEAL, *supra* note 14, at § 7.11; *Stock Redemption, supra* note 22, at 1000-05. N.J. STAT. ANN. § 14A;7-6(3) (West 1969), *see* note 44 *supra.*

52. MODEL ACT § 15.

53. *Id.*, § 16.

54. H. BALLANTINE, CORPORATIONS § 211 (rev. ed. 1946) [hereinafter cited as H. BALLANTINE]. A share which has a higher priority with respect to the asset distributions than other shares cannot, at the same time, be part of the residual equity interest.

55. The Comments to §§ 15 and 16 are of no assistance in this regard. They do not discuss "special classes" nor do they give any indication of whether redemption of common shares is allowable.

56. Also, the term "special classes" has been used in statutory provisions for many years. While the cases have not defined the term, they do not equate it with "preferred" shares. *See* Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 A. 887, *aff'd*, 22 Del. Ch. 394, 2 A.2d 249 (1937).

natively, the words "or special classes" are intended to authorize the issuance of shares with some particular advantages different from the preferences usually associated with preferred shares, the statute contains no expression of what those advantages might be.

The classic notion is that the preferred shares enjoy a priority over the common regarding asset distributions from the corporation through special dividend rights and liquidation preferences.[57] Perhaps, then, a "special class" consists of shares enjoying a particular advantage over the common shares with respect to something other than asset distributions. Professor Ernest Folk stated that "special classes" of shares may be those which "possess some distinctive or unusual right or power which, if exercised, could significantly change the internal corporate structure."[58] Under this approach, a redemption right of itself would not be sufficient to constitute a share as "special class" since exercise of the redemption privilege would not significantly alter the internal corporate structure. However, it could exist as an additional advantage of an otherwise special share. This approach may consider as "special," and therefore redeemable, shares possessing plenary voting power. On the other hand, shares with less than full voting power may not be redeemable. The general criticism of redeemable common shares is that they allow ultimate risk-takers to obtain advantages to the detri-

57. See Goldman v. Postal Telegraph, Inc., 52 F. Supp. 763 (D. Del. 1943); Starring v. American Hair & Felt Co., 21 Del. Ch. 142, 191 A. 887, *aff'd*, 22 Del. Ch. 431, 2 A.2d 249 (1937). *See* 12 W. FLETCHER, *supra* note 17 at § 5443.

58. Folk, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C. L. REV. 768, 834 (1965) [hereinafter cited as Folk]. In this article, Professor Folk thoroughly analyzes the North Carolina Business Corporation Law which, when enacted in 1955, was one of the most advanced corporation statutes in the United States, as well as a recent treatise thereon, ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE (1964) [hereinafter cited as ROBINSON]. Professor Folk analyzed §§ 55-40(a) and 55-52 of the North Carolina Business Corporation Act, N.C. GEN. STAT. §§ 55-50 to 52 (1975 Repl. Vol.). Section 55-40(a) authorizes the creation and issuance of preferred or special shares (similar to MODEL ACT § 15) and § 55-52 authorizes the invasion of stated capital to redeem or purchase shares in six specific situations. He gives as an example of a "special class" under his generalization a class of common shares which has, to the exclusion of another class, the right to dissolve the corporation at will. He contrasts this right with one in which a corporation has two classes of common shares, one entitled to elect two and the other entitled to elect three of its directors. Neither of these classes is special, because neither has a right which would significantly change the internal corporate structure. Also the latter example poses two unanswered questions of which of the two classes of voting shares is "special," and why one class is special and not the other. Professor Folk concluded that redemption of some common shares "is not necessarily bad," when there remains a class of common stock which is not redeemable. Folk, *supra* at 835.

ment of creditors or other shareholders.[59] The suggested distinction would appear to underscore that criticism.

Another approach would be simply to determine whether a common share which includes a redemption right is by virtue of that right a special share.[60] There has been little litigation on this point under any statutory scheme. However, two cases, *Starring v. American Hair & Felt Corporation,*[61] and *Lewis v. H. P. Hood & Sons, Inc.*[62] are widely cited in this regard.[63]

In *Starring*, the capital structure of defendant corporation consisted of two classes of preferred shares and full voting common shares. The corporation's certificate of incorporation expressly provided that the common shares would be redeemable. The majority of the common shares were held by members of the hide tanning industry. Plaintiff, to whom some common shares had been transferred, was not a tanner. The corporation, in an attempt to keep the common shares out of the hands of non-tanners, decided to redeem the common shares held by all shareholders and then to reissue them to those shareholders who were tanners.[64] Plaintiff alleged that the call for redemption of the common shares was invalid because the statute authorized the redemption of only preferred or special shares. The defendant contended that the common stock was "special stock" within the meaning of the statute.[65] The issue presented was whether common shares can be considered as special

59. *See* Dodd, *supra* note 2, at 719-22.

60. Mr. Robinson, in the treatise commented on by Professor Folk, suggests that under the North Carolina statute, redeemable common shares constitute a "special class" by virtue of the redemption provision. ROBINSON, *supra* note 58, § 122. *See* F. H. O'NEAL, *supra* note 15, at § 7.11 & § 7.11 n.3.

61. 21 Del. Ch. 380, 191 A. 887, *aff'd,* 22 Del. Ch. 394, 2 A.2d 249 (1937).

62. 331 Mass. 670, 121 N.E.2d 850 (1954), *commented in* 35 B.U. L. REV. 190 (1955); 43 GEO. L. J. 302 (1955); 54 MICH. L. REV. 132 (1955); 1954 U. ILL. L. F. 688; 103 U. PA. L. REV. 819 (1955).

63. *See, e.g.,* Folk, *supra* note 58, at 834; Ford, *Share Characteristics under the New Corporation Statutes,* 23 LAW & CONTEMP. PROB. 265, 280 (1958); *Stock Redemption, supra* note 22, at 988.

64. There are other cases in which the purported redemption of common shares has been attempted to prevent shares from falling into the hands of non-industry members. *See, e.g.,* Glen Falls Ins. Co. v. National Bd. of Fire Underwriters Bldg. Corp., 314 N.Y.S.2d 80, (1970), *aff'd,*318 N.Y.S.2d 915 (1971) and *In re* West Waterway Lumber Co., 59 Wash.2d 310, 367 P.2d 807 (1962).

65. DEL. CODE ANN. tit. 8, § 2059 (1935) provided in part that "whenever any corporation . . . shall have issued any *preferred or special shares* it may . . . redeem all or any part of such shares." (Emphasis added).

stock[66] and thus subject to redemption. Although the court acknowledged its inability to find a definition of the term "special stock," it was unnecessary for it to articulate a distinction between preferred and special stock. The court stated that "special stock" must contain some "preference, and relative, participating, optional or other special rights" in relation to other shares.[67] It then examined several distinctive features of the common stock, such as its exclusive voting power to the exclusion of the preferred shares and its subordinate position in any asset distribution, to determine whether they constituted preferences or special rights. The court concluded that they did not. With respect to the exclusive voting power, the court construed the statute to exclude plenary voting rights as special rights. The subordinate position in relation to the preferred shares in asset distribution was considered a burden on the common shares. In contrast, "special stock" was said to possess the characteristic of "rights or favors in relation to other stock."[68] However, in examining the attributes of the common stock, the court failed to mention the fact that it was redeemable, and it did not consider whether this feature was a right or favor in relation to other stock as to make the shares "special."[69]

In contrast, the *Lewis* case does not consider whether common

66. Plaintiff argued that the term "special shares" was synonymous with "preferred shares." The court, in analyzing this interpretation of the term, reasoned that such an interpretation might imply that the legislature had added the phrase "special stock" as

> an abundance of precaution—to make sure that special rights such as were "participating and optional" for instance, which might be argued as not typically belonging to a stock called preferred, would nevertheless be clearly appropriate to a stock called special and so give to such stock the desired redeemable character.

191 A. at 890.

67. *Id.* at 891.

68. *Id.* In a subsequent case, Hartford Accident & Idem. Co. v. W.S. Dickey Clay Mfg. Co., 26 Del. Ch. 16, 21 A.2d 178 (1941), *aff'd,* 26 Del. 411, 24 A.2d 315 (1942), the Delaware Supreme Court again was confronted with the issue of whether common stock was special stock, so that the holders would have the right to vote as a class on certain amendments to the certificate of incorporation. Such right was given by statute to preferred or special stock only if the amendment would change the relative rights or preferences of such preferred or special classes. DEL. CODE ANN. tit. 8, § 2058 (1935). The court, relying on *Starring,* concluded that special shares are shares "having some unusual or superior quality not possessed by another class of shares." 24 A.2d at 318. *See also* Gottlieb v. Hayden Chemical Corp., 33 Del. Ch. 82, 90 A.2d 660 (1952); Arsht & Stapleton, *Delaware General Corporation Law: 1969,* 25 BUS. LAW. 287, 292 (1969).

69. Since all of the common shares were redeemable, there was no "relative right or favor" in relation to other common shares. The preferred shares apparently were not redeemable, however.

shares are special shares. In that case the Massachusetts Supreme Court held that redemption of common shares is allowable under the applicable statute when provided for in the articles of association. The plaintiff in *Lewis* was an employee of the defendant, a closely held corporation. He sued to enjoin enforcement against him of a provision in the defendant's articles of organization providing for the redemption or call of any common shares at book value upon the unanimous vote of the board of directors.[70] The statute authorized the issuance both of preferred and common shares of two or more classes of stock with such "preferences . . . restrictions and qualifications as are stated in the agreement of association."[71] The court indicated that the statute did not specifically authorize the redemption of either preferred or common stock. However, it had long been established that redemption or call provisions were allowable with respect to preferred shares.[72] The court was unable to find a reason for not extending the same treatment to common shares, since the redemption provision was as much a restriction or qualification of the common stock as of the preferred.[73] The rationale and approach in these cases could be used to support the conclusion that common shares either can be, or cannot be, made redeemable under section 15 of the Model Act.

Since the Delaware statute interpreted in *Starring* is more like the provisions of section 15 of the Model Act than the Massachusetts statute in *Lewis,* the decision in the former case ought to be persuasive authority for the conclusion that common shares are not redeemable. *Starring* states the criteria for special shares as being "preferences, and relative, participating, optional or special rights," and that characteristics which impose relative burdens on a class of shares do not qualify such shares as special.[74] However,

70. The North Carolina statute would allow invasion of stated capital to effect this type of transaction as a separate, exceptional transaction to which the general repurchase of shares limitation would not apply. N.C. STAT. ANN. § 55-52 (1975 Repl. Vol.). *See* note 25 *supra.*

71. MASS. GEN. LAWS ANN. ch. 156, § 14 (West 1979) provided in part that a corporation be authorized to issue "two or more classes of stock with such preferences, voting powers, restrictions, and qualifications" as are fixed in the agreement of association or the articles of incorporation.

72. Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N.E. 383 (1933), *cited in* 121 N.E.2d at 853.

73. 121 N.E.2d at 853.

74. 191 A. at 891.

the criteria and the approach in *Starring* do support an argument that under Section 15, redeemable common shares could be considered as "special shares." The court in *Starring* did not analyze whether the redemption feature itself could be a preference or relative right. If at least two classes of common shares exist, one of which by its terms is redeemable, that class does enjoy a preference or special right relative to the other class of common.[75]

The *Lewis* decision is based on a statute unlike section 15, and could, therefore, be considered of little relevance. However, the methodology used by the court in that case supports the conclusion that redeemable common shares are authorized in section 15 of the Model Act. The court proceeded on the premise that the provisions of the corporation statute were to be liberally construed. The Massachusetts statute contained no limit on the redemption of common shares.[76] Hence a redemption provision was authorized because it was not expressly prohibited. This same rationale could be used in the interpretation of section 15 of the Model Act. It is clear that the Model Act is intended to be a flexible, "liberal" corporation statute. The comment to section 15 states, with respect to the types of shares and their relative rights and preferences, that the variations in characteristics are limited "only by the imagination of the draftsman."[77] Interpreting section 15 consistently with the Massachusetts court, redeemable common shares should be allowed since there is nothing expressly prohibiting them.

The conclusion that section 15 permits redeemable common

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75. DEL. CODE ANN. tit. 8, § 151(b) (Rev. 1974) was recently revised to eliminate the ambiguous and troublesome term "special classes" and to provide expressly that, with limited exceptions, only shares entitled to dividend or liquidation preferences can be redeemed. Redemption is thus generally limited to otherwise preferred shares.

Although § 151(b) does not expressly state that common shares generally may not be redeemed, commentators believe it does have that intent and effect, particularly since it states two specific instances in which "[a]ny stock" may be redeemed. DEL. CODE ANN. tit. 8, § 151(b) (Rev. 1974). *See* Arsht & Black, *The Delaware General Corporation Law: Recent Amendments*, 30 BUS. LAW. 1021, 1028-31 (1975); Smith, *Fair Price and Redemption Rights: New Dimensions in Defensive Charter Amendments*, 4 DEL. J. CORP. L. 1, 25 (1978).

76. 121 N.E. at 852, 853.

77. MODEL ACT § 15, Comment. The Comment states that the original concept of the rather stringent limitations of preferences as to dividends and liquidation has evolved "to the multitude of variations in the characteristics of shares limited today in the Model Act and in most states only by the imagination of the draftsman developed in pace with the increasingly complex demands of an expanding economy." *See Stock Redemption, supra* note 22, at 988.

shares could also be the result of circular reasoning: Redeemable common shares are special since they have some distinctive right (the redemption right); section 6 allows the redemption of preferred or special shares; therefore section 6 allows the redemption of common shares. The *Starring* court might consider the error in this reasoning to be the assumption that redemption is an attribute of "special shares."[78] The *Lewis* court looked directly at the redemption characteristic of the shares, and determined that if it could be a feature of preferred shares, it could also be a feature of common shares.

In analyzing section 15 a symmetrical approach could be used. Section 15 authorizes the issuance of preferred shares with the characteristics of redemption, dividend and liquidation preferences, and conversion privileges. The section does not presume that only shares which are otherwise preferred can be issued with these rights. Likewise, "special classes" of shares ought to consist of shares which possess at least some of these rights. And one right which could distinguish these shares, and yet not confer upon them all of the classic prefferred share rights, would be redemption.

A frequently stated argument is that from a corporate finance or capital structure point of view, redeemable preferred shares may be used by a corporation to attract necessary capital, without incurring debt and also without diluting the voting rights and residual equity interests of the common shares. Redemption is a means of eliminating certain senior shareholders when their capital is no longer needed or when it may be replaced by less expensive refinancing. On the other hand, the common shareholder foregoes the security of the preferred shares and bears the ultimate risk that the enterprise will fail, in exchange for the expectation of capital appreciation and voting control.[79] It is thus inappropriate that the

78. Since the court did not consider this issue, this assertion is entirely speculative. It is, however, curious that in inquiring as to the distinctive aspects of the shares, the court did not discuss the redemption feature. It appears that the court assumed the premise that only shares which are otherwise "special" can be redeemed. Of course, the fact that the certificate of incorporation stated that *all* common shares were redeemable was a factor in this conclusion.

79. *See* 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS 128, 152, 160, 165 (5th ed. 1953) [hereinafter cited as A. DEWING]; BALLANTINE, *supra* note 54, at § 218; Dodd, *supra* note 2, at 724-25; Kessler, *Share Repurchases Under Modern Corporation Statutes,* 28 FORD. L. REV. 637, 645 (1959-60) [hereinafter cited as Kessler].

common shares, with which lies the ultimate risk, be redeemed.[80]

This argument has some appeal if all common shares are subject to redemption. However, if there are more than one class of common shares, one of which is not redeemable, the perceived risk in redemption of common shares is avoided.[81] The difficulty with this

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80. This ignores the fact that under the statute common shares may be repurchased. Upon the corporation and shareholder, a repurchase has the same economic effect as a redemption. Money is withdrawn from the corporation to the possible detriment of creditors and senior security holders and paid to the shareholder.

81. Professor Folk makes this same point. Folk, *supra* note 58, at 835. New York by statute has accomplished this by providing that "[n]o redeemable common shares . . . shall be issued or redeemed unless the corporation at the time has outstanding a class of common shares that is not subject to redemption." N.Y. BUS. CORP. LAW § 512(c) (McKinney 1963). *See* de Capriles & McAniff, *The Financial Provisions of the New (1961) New York Business Corporation Law*, 36 N.Y.U. L. REV. 1239, 1245 (1961) [hereinafter cited as de Capriles & McAniff].

New Jersey has gone further. N.J. STAT. ANN. § 14A:7-6 (West 1979 Supp.) provides in part:

> (1) A corporation may provide in its certificate of incorporation for one or more classes or series of shares which are redeemable, in whole or in part, at the option of the corporation in cash, its bonds or other property, at such price or prices, within such period or periods, and under such conditions as are stated in the certificate of incorporation. A sinking fund may be created for the redemption of any class or series of redeemable shares . . . .
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> . . . .
>
> (3) A corporation may provide, in its original certificate of incorporation or by an amendment approved by unanimous vote of the shareholders, for one or more classes or series of shares which are redeemable, in whole or in part, at the option of the shareholder. Subject to the restrictions imposed by section 14A:7-16, such shares may be redeemable in cash, bonds of the corporation or other property, at such price or prices, within such period or periods and under such conditions as are stated in the certificate of incorporation, and such shares may also be redeemable at the option of the corporation, as provided in subsection 14A:7-6(1). The certificate of incorporation may be amended to delete or change a provision for shares redeemable at the option of the shareholder only with the unanimous approval of the holders of such shares. A provision for shares redeemable at the option of the shareholder shall become invalid when the number of holders of such shares, other than directors, officers, employees and the spouses of such persons, shall become 25 or more. . . .

The Commissioner's comments to § 14A:7-6 note in particular the potential benefit of redemption provisions in the context of the closely held corporation. They indicate that the section is intended to authorize redeemable common shares and to omit even the requirement under the New York statute that a non-redeemable class of common shares exists. N.J. STAT. ANN. § 14A:7-6 (West 1969), Comment. This is in clear contrast to the recent revision of the Delaware statute which generally eliminates the redemption of other than preferred shares. *See* note 75, *supra*.

However, the New Jersey approach is qualified. Although § 14A:7-6 allows the issuance of redeemable common shares, § 14A:7-16(5)(c) prohibits the purchase or redemption of shares unless thereafter there remains "one or more classes or series of shares possessing, among

approach is that the Model Act has no such requirement. However, in a specific instance under the Model Act, there may be more reason to uphold the validity of a redeemable class of common, if there is a separate class of nonredeemable common.

An additional reason for extending the redemption provision under the Model Act to common shares is that to do otherwise perpetuates a formal, and in some specific situations inconsequential, distinction between preferred or special shares on the one hand and common on the other. A class of stock which simply has a dividend preference (a separate amount), shares in the general dividend distribution thereafter, and also has full voting rights and a redemption provision could be labeled preferred in the articles of incorporation. Alternatively, such a class could be referred to as "Class A common" in the articles of incorporation. It is illogical to authorize the redemption of the shares in the first instance, but not in the second.[82]

C. *Uncertainties in Application of the Model Act*

Not only are the Model Act provisions that relate to redemption ambiguous regarding the types of transactions and securities covered, but also the provisions themselves, and their interrelationships are unclear in certain instances.

The interrelationship of the three Model Act sections can be ba-

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them collectively, voting rights and unlimited residual rights as to dividends and distribution of assets on liquidation." N.J. STAT. ANN. § 14A:7-16(5)(c) (West 1969). The comment to this subsection states that it is required because, unlike the MODEL ACT, the New Jersey statute does not limit redemption to preferred or special shares. *Id.*, Comment.

82. In Zahn v. Transamerica Corp., 162 F.2d 36 (3rd Cir. 1947) the Axton-Fisher Company had a capital structure consisting of preferred stock, Class A common and Class B common. The Class A, which was described in the charter as common stock, was entitled to a cumulative dividend preference of $3.20, and then to an equal share in dividends after the Class B had received $1.60. On liquidation it received twice as much per share as the Class B; it was convertible into Class B stock and also redeemable. Regular voting rights were vested exclusively in Class B. The Class B shareholder, knowing of a significant increase in the market value of the corporation's major asset, caused the corporation to redeem the Class A stock, and then liquidated the corporation, taking for itself the appreciated value of the assets. The action of the Class B shareholder was held to be a breach of fiduciary duty owed to Class A. The rights of the Class A stock were those typically associated with preferred shares. In an earlier case involving the same event, Taylor v. Axton-Fisher Tobacco Co., 295 Ky. 226, 173 S.W.2d 377 (1943) the court stated that the Class A stock was "in the nature of secondary preferred stock." 173 S.W.2d at 378. *See also* BALLANTINE, *supra* note 54, at § 211.

sically stated. Section 6 authorizes a corporation to invade stated capital to effect "the retirement of its redeemable shares by redemption or by purchase at not to exceed the redemption price."[83]

Section 66 qualifies the right to invade granted in section 6 by providing that

> [n]o redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent, or when such redemption or purchase would render it insolvent, or which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.[84]

Finally, section 67 states the effect of a redemption or the purchase of redeemable shares on the corporation's capital structure. "When redeemable shares . . . are redeemed or purchased by the corporation, the redemption or purchase shall effect a cancellation of such shares. . . ."[85]

Generally, section 6 of the Model Act affords creditors protection against the shareholders. The corporation is authorized to purchase shares of its stock only from earned surplus or capital surplus; thereby preserving stated capital as a cushion for the benefit of creditors. The section permits four exceptions to this general approach and appears to authorize the corporation to invade stated capital to effect any of these four transactions.[86]

The comment to section 6 contains no indication of the draftsmen's purpose in creating these exceptions.[87] One explanation for

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83. MODEL ACT § 6. The term "retirement" appears only in § 6. There is no provision in the text of the Act giving it any substantive meaning or effect. The Comments to §§ 67 and 68, in discussing substantive provisions regarding cancellation, state in part "[i]n normal expectation shares that have been redeemed are by that fact retired and shares that have been purchased are subject to retirement at the option of the directors . . . . The Model Act carries out this underlying business expectation." MODEL ACT §§ 67 & 68, Comment. It therefore appears that the MODEL ACT intends that the term "retirement" not mean something different from cancellation. Some states use the term "retirement of stock" as the comparable procedure to cancellation under the MODEL ACT, *e.g.*, DE. CODE ANN. tit. 8, § 243 (Rev. 1974). *See* 11 W. FLETCHER, *supra* note 17, at § 5309.

84. MODEL ACT § 66. The first limitation on the redemption right, that of insolvency, is also stated in the last paragraph of § 6.

85. MODEL ACT § 67.

86. *See* note 4, *supra.*

87. No statement whatever is made regarding the first three exceptional transactions; re-

the exceptions is that in each of the four stated transactions the benefits accruing to the corporation outweigh the disadvantage or potential harm to creditors.[88] Even with respect to these transactions, section 6 afords some protection to creditors by providing that purchases of shares by a corporation shall be prohibited when the corporation is insolvent or would be rendered insolvent thereby.[89]

The first clause of section 66 restates this insolvency restriction.[90] The second clause affords the senior shareholders protection similar to that offered the creditors. After any redemption or purchase of redeemable shares, net assets (assets minus liabilities)[91] must be at least sufficient to pay any remaining senior or equal ranking share-

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garding redemption, however, the Comment states:

> In the case of redeemable shares, the Model Act permits their redemption or purchase at a price not exceeding the redemption price, without stockholder assent, even though this results in an impairment of capital, subject always to creditors' rights as stated above. But capital, though impaired, is not reduced until the statutory steps are taken under section 67 or section 68.

MODEL ACT § 6, Comment.

88. *See* Hackney, *supra* note 10, at 1398; Kessler, *supra* note 79, at 653-60. Mr. Hackney indicates that perhaps this is true with respect to the transactions covered by the exceptions of § 6(a), (b) and (d), in which situations the amount of cash taken out of the corporation and paid to the shareholders is relatively small. He believes that appraisal right payments can entail significantly larger sums, and correspondingly more serious risk to creditors.

Professor Kessler maintains that only in the transactions covered by exceptions § 6(b) and (c) can the interest of the corporation outweigh the harm to creditors. Kessler, *supra* note 79, at 660. Regarding redemption, he states that businessmen consider redeemable stock like a debt, and they are anxious to retire it through redemption as soon as possible to eliminate the claim on earnings payable to the holders thereof, so that profits may be paid only to the common shareholders. Redemption is in the best interest of the corporation, or better stated, of the common shareholder. *Id.* at 645. However, on balance he believes that creditors can be seriously harmed by a share redemption. Although the redemption cannot cause insolvency, it does reduce capital and hence the amount of cushion to the creditors is diminished. *Id.* at 654-56.

89. The insolvency limitation is contained in a separate paragraph and is intended to apply to both the general authorization to purchase from earned or capital surplus and the four extraordinary transactions in which invasion of stated capital is authorized. The Comment to § 6 makes this point clear. "The most fundamental restriction is inherent in the corporate form itself, that is, that the owner may not prefer himself to the disadvantage of his creditor . . . . Thus the Model Act forbids any such acquisition [of its own shares] when the corporation is insolvent or would make it so. . . . This limitation is factual and current, not formal or historical. It is pervasive and absolute." MODEL ACT § 6, Comment.

90. With several qualifications to be discussed; *see* notes 114-116 *infra*, and accompanying text.

91. Section 2(i) of the MODEL ACT defines "net assets" as "the amount by which the total assets of a corporation exceed the total debts of the corporation."

holders the amount due them on involuntary dissolution.

The provisions of section 6 insofar as they apply to redemptions and purchases of redeemable stock present several uncertainties.

1. Redemption from Alternative Sources

First, as previously noted, section 6 does not expressly authorize the invasion of stated capital to redeem or to purchase redeemable shares. It merely eliminates the limitation that the purchase be made from unreserved and unrestricted earned or capital surplus. It is clear, however, that the section does contemplate the invasion of stated capital to effect a redemption or purchase of redeemable shares, as well as the other exceptional transactions. In the first clause of the first paragraph and in the introductory clause of the third paragraph, section 6 explicitly authorizes a corporation to purchase or acquire its shares. Under the accounting scheme in the Model Act, a corporation's net assets are reflected in either stated capital or earned or capital surplus. If the general limitation authorizing purchases only from unrestricted or unreserved earned or capital surplus is removed, by implication purchases can be made from stated capital or earned or capital surplus. As a consequence, the corporation can elect to make the redemption from earned or capital surplus or stated capital. This flexibility is confirmed in the statute. The introductory phrase to the third paragraph of section 6 reads, "[N]otwithstanding the foregoing limitation, a corporation *may* purchase or otherwise acquire its own shares. . . ."[92]

The corporation is empowered to redeem or purchase its redeemable stock at a price not in excess of the redemption price to the extent of stated capital, but it is not required to do so. Assuming a corporation has funds available as earned or capital surplus and as stated capital, it apparently has the right, subject to the limitations in section 66, to elect from among these sources to effect a

92. MODEL ACT § 6 (emphasis added). *See also* Hackney, *supra* note 10, at 1398; Kessler, *supra* note 79, at 651. In the Annotations to § 6, 1 MODEL ACT ANN. 260, a number of state statutes are listed which authorize the purchase of shares out of stated capital in the exceptional transactions. With respect to redemption, some statutes listed explicitly provide that redemption may be made from stated capital. *See, e.g.*, ARK. STAT. ANN. § 64-105 (Rep. Vol. 1966). However, many others, though listed, have a provision like § 6. *See, e.g.*, ILL. REV. STAT. ch. 32, § 157.6 (Smith-Hurd 1954); KY. REV. STAT. ANN. § 271A.030 (Baldwin Rep. Vol. 1973).

redemption or purchase of redeemable shares. The Model Act does not authorize the use of stated capital only in the absence of other sources. It simply is silent on this point.[93]

2. Consequence of Redemption to Capital Structure

Ultimately there is little prejudice to the shareholders, regardless of the source used.[94] This is due to the reduction in stated capital following the cancellation of the redeemed or purchased shares. On reduction in stated capital, the funds used to effect the redemption or purchase will be charged against stated capital. Thereupon, if earned surplus was used as the source, it would be restored, and the purchase price charged to stated capital. If stated capital was the source, the reduction in capital would permanently reflect the reduction which was in effect accomplished at the time of the transaction.[95]

However, the sequential operation of the various sections of the Model Act does create for a short period an ambiguity both as to the status of the shares redeemed or purchased and the funds expended therefor. Assume a simply fact situation in which 10 preferred shares are redeemed or purchased for $100 each, their par value, and the $1000 necessary to accomplish the transaction was taken from either earned surplus or stated capital.[96] Regardless of

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93. Mr. Hackney raises the question of whether § 6 allows the use of stated capital when other sources exist. Hackney, *supra* note 10, at 1398. Professor Kessler replies by stating that "it seems clear that the drafter intended that such purchases be permitted." Kessler, *supra* note 79, at 656 n.58. Again, the Comment to § 6 is of no assistance.

94. The creditors and shareholders, of course, are prejudiced to the extent authorized by § 66. *See* text accompanying notes 111-134, *infra*.

95. There is no attendant reduction in capital when stated capital is used to effect the other three exceptional transactions. If stated capital was used even though other sources existed, there would be a more serious harm to creditors and senior shareholders inasmuch as the other sources would remain available to pay dividends on the junior shares.

96. Such a fact situation could be as follows:

Assets	Liabilities	
$15,000	$ 8,000	
	$ 2,000	stated capital, preferred shares
	2,000	stated capital, common shares
	0	paid in surplus
	$ 4,000	
	3,000	earned surplus
$15,000	$15,000	

the source of the funds selected for this purpose, the reacquisition of the shares effects their immediate cancellation. Section 67 of the Model Act states in part that "[w]hen redeemable shares . . . are redeemed or purchased by the corporation, the redemption or purchase shall effect a cancellation of such shares, and a statement of cancellation shall be filed as provided in this section."[97] However, the act of redemption or purchase does not effect an immediate reduction of capital by the amount of stated capital represented by such shares. Section 67 provides that reduction in stated capital takes place somewhat later when the secretary of the state of incorporation files a statement of cancellation, which has been prepared and submitted to him for review by designated corporate officers.[98]

Assume 10 of the preferred shares are redeemed at $100 each. $1000 of the earned surplus or the stated capital could be used. The redemption price of the preferred shares might often be slightly above the par and liquidation preference, since it may include a premium, plus accrued and unpaid dividends.

97. MODEL ACT § 67.

98. The statement of cancellation shall be executed in duplicate by the corporation by its president or a vice president and by its secretary or an assistant secretary, and verified by one of the officers signing such statement, and shall set forth:
    (a) The name of the corporation.
    (b) The number of redeemable shares cancelled through redemption or purchase, itemized by classes and series.
    (c) The aggregate number of issued shares, itemized by classes and series, after giving effect to such cancellation.
    (d) The amount, expressed in dollars, of the stated capital of the corporation after giving effect to such cancellation.
    (e) If the articles of incorporation provide that the cancelled shares shall not be reissued, the number of shares which the corporation will have authority to issue ubemized by classes and series, after giving effect to such cancellation.

    Duplicate originals of such statement shall be delivered to the Secretary of State. If the Secretary of State finds that such statement conforms to law, he shall, when all fees and franchise taxes have been paid as in this Act prescribed:
    (1) Endorse on each of such duplicate originals the word "Filed," and the month, day and year of the filing thereof.
    (2) File one of such duplication originals in his office.
    (3) Return the other duplicate original to the corporatin or its representative. Upon the filing of such statement of cancellation, the stated capital of the corporation shall be deemed to be reduced by that part of the stated capital which was, at the time of such cancellation, represented by the shares so cancelled. . . .

MODEL ACT § 67.

The Comment to § 67 supports the interpretation that the shares are cancelled by redemption, but that capital is not thereby reduced. "When redeemable shares are redeemed or purchased, the corporation is under a mandatory duty to *file a statement of cancellation with the secretary of state. Thereupon* the stated capital of the corporation is automatically

During the interim period[99] between the conclusion of the redemption transaction[100] and the filing of the statement of cancellation by the secretary of state, earned surplus, if it was the fund used, would not be restricted by the $1000 needed to effect the reacquisition. Section 6 provides that earned surplus shall be restricted[101] by the amount used to purchase shares when the shares purchased are treasury shares. However, redeemed or purchased redeemable shares are deemed cancelled by the very transaction. Cancelled shares, by definition, are not treasury shares.[102] If there is

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reduced by the amount which until then was represented by the cancelled shares." MODEL ACT § 67, Comment (emphasis added).

Under other statutory schemes, stated capital is reduced immediately upon the conclusion of the redemption or purchase. N.J. STAT. ANN. § 14A:7-18(1) (West 1969). "When shares of a corporation are reacquired out of stated capital . . . the reacquisition shall effect their cancellation. . . ." N.J. STAT. ANN. § 14:77-18(3). "Except as otherwise provided in this subsection, upon the cancellation of reacquired shares of any class or series the stated capital of the corporation shall be reduced by the amount represented by such shares before their cancellation." The Commissioners' comment indicates that "reduction of stated capital takes place upon cancellation of the shares." N.J. STAT. ANN. § 14A:7-18 (West 1969), Comment.

See N.Y. BUS. CORP. LAW § 515(a) (McKinney 1963). "Shares that have been issued and have been purchased, redeemed or otherwise reacquired by a corporation shall be cancelled if they were reacquired out of stated capital. . . ." § 515(d). "When reacquired shares . . . are cancelled, the stated capital of the corporation is thereby reduced by the amount of stated capital represented by such shares. . . ." *Id.*

99. Section 67 obligates the appropriate officers to deliver the statement of cancellation to the secretary of state. Presumably it is to be done as soon as practicable. However there may be some delay in the filing of the statement by the secretary of state.

100. The MODEL ACT, moreover, does not state when the redemption takes place. Is it the time at which the corporation calls the shares for redemption, when the event triggering the redemption provision occurs, or the date of payment? Thus the beginning of this hiatus, which ends upon the filing of the statement of cancellation, is uncertain. Section 33, regarding the voting of shares, does provide that

> On and after the date on which written notice of redemption of redeemable shares has been mailed to the holders thereof and a sum sufficient to redeem such shares has been deposited with a bank or trust company with irrevocable instructions and authority to pay the redemption price to the holders thereof upon surrender of certificates therefor, such shares shall not be entitled to vote on any matter and shall not be deemed to be outstanding shares.

MODEL ACT § 33.

101. A restriction means that the earned surplus to the extent of the restriction is not available as a source of dividends, or from which further purchases of shares can be made. MODEL ACT § 6, Comment.

102. Section 2(h) of the MODEL ACT defines "treasury shares" as "shares of a corporation which have been issued, have been subsequently acquired by and belong to the corporation, and have not, either by reason of the acquisition or thereafter, been cancelled or restored to the status of authorized but unissued shares." Thus if the redeemed shares are cancelled, they cannot be treasury shares.

no restriction on the earned surplus, presumably its full amount, including the amount used to effect the redemption or purchase, would remain available as a source for dividends and other purchases.[103]

If the corporation redeems or purchases the redeemable shares from stated capital, the full amount of the earned surplus remains unrestricted. Again, there is no reduction in capital until the statement of cancellation is filed, even though funds from stated capital were directly used to effect the redemption. The comment to section 6 states that the capital is impaired when stated capital is used as the source for the redemption or repurchase of redeemable shares.[104]

The practical consequence of selecting either earned surplus or stated capital is not great. After the statement of cancellation is filed, the stated capital is reduced and the full amount of earned surplus is available for other purchases or dividends.[105] However, if

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In the example stated in note 96 *supra,* assets have been reduced by $1000, the amount of the purchase price. But it is not clear where the off-setting entry is to be made. Obviously after capital is reduced, the stated capital represented by the preferred shares will be reduced by $1,000 and earned surplus will be $3,000. During the interim the shares are cancelled, although capital is not reduced by the amount of stated capital represented thereby. Earned surplus is not restricted since the redeemed preferred shares are not treasury shares.

103. This problem is a specific instance of the general problem which the MODEL ACT's theory of restricting earned surplus is intended to resolve. Absent the restriction, even though funds have been expended to purchase treasury shares, the full amount of the earned surplus remains to be used over and over. *See* Kessler, *supra* note 79, at 641 & 641 n.15.

104. MODEL ACT § 6, Comment. The effect of such impairment is unclear. It appears to have little practical significance since the full amount of any earned or capital surplus would still be available for distribution through dividend or share repurchase.

105. The balance sheet in the example stated in note 96 *supra* after the reduction would be:

Assets	Liabilities	
$14,000	$8,000	
	1,000	stated capital, preferred stock
	2,000	stated capital, common stock
	0	paid in surplus
	3,000	
	3,000	earned surplus
$14,000	$14,000	

See notes 134 and 136, *infra,* for a discussion of the proper treatment of the situation in

earned surplus is the source, the status of that fund is uncertain until the statement of cancellation is filed.

3. Stated Capital as Source for Redemption and Repurchase

Section 6 contains other ambiguities. The use of the word "may" in the section grants a corporation the right, by implication, to invade stated capital to redeem shares. The section does not require the invasion. Thus, the use of "may" raises the question of whether the board of directors could refuse to redeem shares if it does not have available earned or capital surplus. The board might determine in the exercise of its business judgment that invasion of stated capital to effect the redemption could jeopardize the corporation's credit and weaken its position with possible lenders. Then the issue would be whether the holders of redeemable shares could force the board to invade stated capital to comply with terms of the redemption provision in the articles of incorporation. Presumably, any such disputes could be resolved by analogy to those cases in which holders of preferred shares sought an order forcing the directors to exercise their discretion and pay a dividend.[106] Since a redemption provision, like the dividend right, is contractual, the issue would be one of interpretation of the pertinent provisions in the articles of incorporation.[107]

The right to use stated capital as the source of funds, as granted in section 6, applies not only to a redemption, but also to the purchase of redeemable shares "at not to exceed the redemption

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which the redemption or purchase price is greater than the stated capital represented by the reacquired shares.

106. *See* Buxbaum, *supra* note 2, at 253-55 and the cases cited therein. In Security Nat'l Bank v. Peters, Writer and Christensen, Inc., 569 P.2d 875 (Colo. App. 1977) the action of the board of directors in not selling certain assets (shares of stock of another corporation) and redeeming the preferred shares with the proceeds, as required by the articles of incorporation, was held to constitute a breach of fiduciary duties and constructive fraud. The members of the board held approximately two-thirds of the common shares. The court found that the board of directors anticipated that the assets would appreciate in value. In failing to sell the assets and redeem the preferred the board was held to have advantaged the common shares at the expense of the preferred.

107. The issue would only arise in those situations in which the corporation is obligated by a provision in the articles of incorporation to redeem, either at a fixed time or at the shareholders' election. Language stating that the corporation shall redeem "out of funds legally available" would probably be sufficient to require the corporation to invade stated capital, since it is a legally available source for redemption. *See* Buxbaum, *supra* note 2, at 266.

price." Such a purchase of redeemable shares would be through a transaction between the corporation and the shareholder on terms different, at least in one respect, from the terms of the redemption provision in the articles of incorporation.[108]

Only section 6 contains the qualification that purchases of redeemable shares be made "at not to exceed the redemption price." The provisions of both sections 66 and 67 apply to redemptions and to all purchases of redeemable shares. Thus, regardless of whether the purchase price is higher or lower than the redemption price, the insolvency and net asset limitations of section 66 are applicable and such shares are considered cancelled pursuant to section 67 from the time of reacquisition.

The provisions of section 67 with respect to cancellation of redeemable shares are based on the rationale that such shares are senior securities which the corporation may wish to reacquire when it is economically advantageous to do so in order to eliminate their claim to dividends and other distributions which take priority over those of the common shares. The general expectation is that such shares are to be retired or cancelled upon reacquisition.[109] If this is the general expectation, the fact that the shares are reacquired pursuant to the redemption provision or through purchase is not critical. Therefore, it is consistent that the same treatment be accorded redeemed or repurchased redeemable shares.[110] However, the cancellation of such shares and the consequent reduction in capital does impose an added burden on the creditors since the diminution in the dollar value of the cushion occurs sooner than they might have anticipated.

The provision in section 6 permitting stated capital to be used in purchasing redeemable shares at no more than the redemption price presents the same disadvantage to creditors. But because the

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108. Obvious examples would be the purchase at a time earlier than the required redemption, or at a price different from the redemption price.

109. The Comment to § 67 states that this is the normal expectation. MODEL ACT § 67, Comment. *See* BALLANTINE, *supra* note 54, at § 261; Kessler, *supra* note 79, at 645.

110. The usual rule as stated in § 67 is that the cancelled shares are returned to the status of authorized, but unissued shares. There is little practical difference from the corporate law point of view between considering redeemable shares purchased before the redemption date as authorized, but unissued or as treasury shares. In either event they could be resold. Of course as unissued shares they could only be sold as provided in § 18 for at least par value. Whereas, as treasury shares they could be resold at a price lower than par value.

creditors are charged with knowledge of the substance of the articles of incorporation and the corporation statute they may be successfully charged with the knowledge that the shares were subject to redemption and that if stated capital were used to accomplish the redemption, the amount of their cushion would be diminished. However, authorizing the invasion of stated capital to make a purchase means that the reduction in value may take place earlier than they had the right to expect.

It is unclear whether section 6 allows the invasion of stated capital in any amount, if the purchase price of the shares is more than the redemption price. Literally the statute appears to allow use of stated capital only if the purchase price is no greater than the redemption price. This is reinforced by the approach of the statute in lifting the general limitation on purchases to unrestricted earned or capital surplus only in the four designated, exceptional transactions.

The rationale for allowing the invasion of stated capital to effect a purchase of redeemable shares is that the creditors would suffer no different financial harm than they might through a redemption. Since they are charged with knowledge of the redemption provisions in the articles of incorporation, there is no addition harm if the purchase of shares is on terms as favorable to the corporation as are redemption provisions. However, such harm may take place sooner. Moreover, even if the purchase were made entirely from capital or earned surplus, section 67 provides that the shares would be cancelled, and stated capital reduced. The stated capital cushion for the creditors will, accordingly, be reduced by the amount represented by the reacquired shares. On the reduction in capital the balance of the purchase price (the excess over the stated capital represented by the reacquired shares) will be charged against earned or capital surplus. Similarly, it seems appropriate to authorize the use of stated capital, up to the amount of the redemption price regardless of what price is paid for the shares. The creditors will suffer no more harm than if the purchase price was equal to the redemption price. The stated capital will be reduced by the same amount and the excess of the purchase price over stated capital will be charged against earned or capital surplus. Furthermore, since section 66 is not as limited in application as section 6, its separate protections will apply regardless of the purchase price paid for the shares.

4. Insolvency Limitation

The insolvency limitation on redemption or purchase of redeemable shares imposed by sections 6 and 66 is the equity variant of insolvency. Under this test a corporation can redeem or purchase redeemable shares as long as there will be sufficient liquidity after the transaction to meet obligations as they become due.[111] Creditors are thereby protected, but only minimally. A large payment to the shareholders through redemption or purchase is permitted if, thereafter, the corporation is capable of meeting its debts. The fact that a large debt due sometime after the redemption might disadvantage creditors is not controlling.[112]

Another issue regarding these insolvency limitations is the uncertainty as to the time at which the test is to be applied. The more widely accepted proposition from the case law has been that the insolvency test must be met at the time each installment of the purchase price is paid, but not at the time the agreement is entered into.[113] The general insolvency restriction contained in section 6 of

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111. MODEL ACT § 2(n) defines "insolvent" as "the inability of a corporation to pay its debts as they become due in the usual course of its business." This definition is distinct from that contained in the federal bankruptcy statute. A person is deemed to be insolvent in the bankruptcy sense if "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors. . . ." 11 U.S.C. § 101(26) (1979).

112. MODEL ACT § 6 contains a similar insolvency restriction. The Comment to § 6 points up another difficulty with the equity approach to insolvency. The Comment states that insolvency is "factual and current, not formal or historical. It is pervasive and absolute." MODEL ACT § 6, Comment. It is difficult as a factual matter to determine if a corporation can meet its obligations as they become due. The amount of total or current liabilities to total or current assets is not controlling. The test and the difficulty of its application are of extreme concern to the directors. Section 48 of the MODEL ACT imposes personal liability on board members for the amount of any distribution, by dividend, share repurchase or redemption or otherwise, in excess of that allowed by the Act, including the insolvency limitation, subject to the defense of good faith reliance upon financial statements and data contained in § 35. However, since the test is not balance sheet oriented, the defense may be more difficult to use successfully.

For a discussion of the distinction between bankruptcy and equity insolvency, *see* 1 COLLIER, BANKRUPTCY §§ 1.19 & 6.30 and cases cited therein.

113. Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935). "It is immaterial that the corporation was solvent and had sufficient [net assets] . . . to make the payment when the agreement was entered into. It is necessary . . . that the corporation should be solvent and have sufficient [net assets] . . . when the payment is actually made." *Id.* at 757-58; *contra,* Wolff v. Heidritter Lumber Co., 112 N.J. Eq. 34, 163 A. 140 (1932).

> [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, in-

the Model Act broadens the applicability of the test. It appears to apply to both points in the transaction.[114] It forbids any *"purchase or payment* for its own shares when the corporation is insolvent or when such purchase or payment would make it insolvent."[115] However, this approach is not carried over into section 66. The prohibition in that section reaches only the "redemption or *purchase* of redeemable shares . . . [when the corporation is insolvent] or when such redemption or *purchase* would render it insolvent."[116] There is no prohibition in section 66 on *payment* for shares when insolvent, or on *payments* which would render the corporation insolvent.

A recent Texas case, *Williams v. Nevelow,*[117] is pertinent in this regard. In that case the corporation purchased shares held by a shareholder, issuing in payment therefor its promissory note, payable in eighty-four monthly installments. Payment of the note was secured by a security agreement covering certain personal property. At the time the transaction was entered into the corporation had earned surplus in excess of the entire amount of the purchase price of the stock. Later, the corporation defaulted on the note. The shareholder, proceeding under the security agreement, arranged for the sale of certain of the secured assets. He in turn purchased the assets, apparently in full satisfaction of the amount due under the note. Shortly thereafter the corporation filed a petition in bank-

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> stead 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.

Id. at 112 N.J. Eq. at 37, 163 A. at 141. *See* Herwitz, *Installment Repurchase of Stock: Surplus Limitation,* 79 HARV. L. REV. 303 (1965)[hereinafter cited as Herwitz]. This issue is less important in the context of a redemption of shares since the redemption price would typically be paid in full, although it need not necessarily be. It is more important in the context of an installment purchase of redeemable shares.

114. MODEL ACT § 6. The "or payment for" language was added to then § 5 of the MODEL ACT by a 1957 revision. Professor Herwitz states that the draftsman intended by this language to codify the time at which this insolvency limitation applied and he "assumed, or at least feared, that the term 'purchase' would only cover the execution of the original agreement, and not the actual payment that might come later." Herwitz, *supra* note 113, at 322. *See also,* Kessler, *supra* note 79, at 677.

115. MODEL ACT § 6 (emphasis added).

116. MODEL ACT § 66 (emphasis added).

117. 513 S.W.2d 535 (Tex. 1974). The case does not deal with a share redemption. It does interpret the word "purchase" as used in an installment purchase transaction.

ruptcy. The trustee in bankruptcy sued to set aside the foreclosure sale on the theory that the sale of assets in satisfaction of the note constituted payment by the corporation for shares of its stock while insolvent.[118] The court defined the word "purchase" as used in its statute which prohibited a corporation from purchasing shares while insolvent[119] to mean a "voluntary transmission of property from one person to another in exchange for a valuable consideration."[120] It concluded that in the context of an installment purchase of stock, the purchase took place at the time of delivery of the promissory note, not at the time of payment of each installment.[121] Thus, the insolvency limitation applied only at the time of delivery of the promissory note. Since payments of the installments do not constitute purchases, the limitation is not applicable at the time of such payments.[122]

After the transaction complained of, the Texas statute was amended to provide that a corporation could not "purchase [its shares] or make payment, directly or indirectly" for its shares while insolvent.[123] The court pointed out that the addition of the

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118. This theory is based on the holding in Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935). In that case the claim of a holder of a promissory note issued by a corporation in exchange for shares of its stock was subordinated to the claims of other creditors, because the transaction "is not really a sale. It is simply a method of distributing a portion of the assets to the stockholder." *Id.* at 756.

119. TEX. BUS. CORP. ACT ANN. art. 2.03(F) (Vernon 1978 Supp.) as in effect at the time of the transaction provided:

> 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.

120. 513 S.W.2d at 537.

121. *Id.* "No statute is known to use the term 'purchase' to mean the act by which the buyer finally parts with tangible property and not to mean a consummated trade which may be the unconditional exchange of a promissory note for stock." *Id.* The court in Robinson v. Wangemann, in contrast, stated that in a repurchase of shares, the corporation did not acquire anything of value. 75 F.2d at 757.

122. TEX. BUS. CORP. ACT ANN. art. 2.03(E) (Vernon 1978 Supp.) is like the second paragraph of § 6 of the MODEL ACT, to the effect that earned surplus is restricted by the amounts used to purchase shares, until the shares are disposed of, either by resale or cancellation. The court reasoned that if the term purchase were to also include cash payments on the note, earned surplus would be doubly restricted, first by the full amount of the exchange price when the shares were transferred and second by the amount of each installment. 513 S.W.2d at 538.

123. TEX. BUS. CORP. ACT ANN. art. 2.03(F) (Vernon 1978 Supp.).

> In no case shall a corporation purchase or make payment, directly or indirectly, for its

term "payment" indicates a distinction between "purchase" and "payment." However, it then obliterated the distinction by stating that the issuance of a secured promissory note could be considered "payment" for the shares.[124]

This case is particularly noteworthy since Texas is a Model Act jurisdiction; and it has an important ramification when applied to section 66 of the Model Act.[125] The insolvency limitation of section 66 applies literally to redemptions or "purchases" of redeemable stock. The insolvency limitation, "purchase of or payment for," contained in section 6 is not carried over into section 66. Following the rationale of the *Williams* case, an argument can be made that the insolvency limitation of section 66 when applied to the installment repurchases of redeemable shares applies at the time the transaction is entered into, and not at the time of payment.[126] The fact that section 66 deals expressly and exclusively with restrictions on redemptions and purchases of redeemable shares supports an inference that this section should control over any inconsistent provision. The counter-argument is that the insolvency limitations of both sections 6 and 66 are applicable. Obviously the limitation in section 66 is applicable. Section 6 may also be applicable since it is the section which authorizes the repurchase of shares and confers the special advantage on redemptions and purchases of redeemable shares. The insolvency limitation contained therein could be considered a condition in exchange for the grant of authority and special rights conferred by the section.

5. Net Asset Limitation

The second limitation contained in section 66 is that after a redemption or purchase of redeemable shares the net assets of the

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own shares when there is reasonable ground for believing that the corporation is insolvent, or will be rendered insolvent by such purchase or payment, or when, after such purchase, or payment, the face value of its total assets will be less than the total amount of its debts.

124. Williams v. Nevelow, 513 S.W.2d at 539.

125. The case did not deal with the Texas enactment of § 66, but with its version of § 6. It seems unlikely, however, that a different interpretation of "purchase" would be applied in the redemption section.

126. The case is limited on its facts to installment sale agreements in which the corporation exchanges its promissory notes for the shares. A transaction in which the shareholder, pursuant to an agreement, conveys the shares to the corporation and the corporation simply pays for them in installments may not fit the court's definition of a purchase.

corporation must be an amount equal to the amount payable upon involuntary dissolution to all shares of equal or senior priority to the redeemed or purchased shares. This limitation is at first glance easier to apply and more readily ascertainable than the insolvency limitations. Unlike the insolvency limitations to which a rather subjective judgment of liquidity is critical, the corporation's net assets are ascertainable with a degree of mathematical certainty from its financial records. Net assets are simply assets minus liabilities.[127] However, the second component of the test, "the amount

127. MODEL ACT § 2(i). The MODEL ACT contains a fairly complete and precise definitional section. It does not indicate the accounting principles to be employed in arriving at the defined amounts. One often discussed example is whether unrealized appreciation in assets is to be considered as part of capital surplus for dividend distribution, or share repurchase purposes. Generally accepted accounting practice is thought to prohibit this. Yet the language of the statute would appear to allow its inclusion. Moreover, the statute does not require that in computing capital or earned surplus generally accepted accounting principles are to be employed. Likewise in computing "net assets" the statute does not indicate whether the assets should be computed at lower of cost or face value as accounting conventions would generally dictate or whether fair current value accounting should be employed. *See generally,* Hackney, *supra* note 10, at 1378-81; Seward, *supra* note 10, at 440-43.

In this regard the new California corporation statute is a considerable improvement over the MODEL ACT. For example, CAL. CORP. CODE ANN. § 500 (West 1977), which sets forth the test for determining the maximum allowable dividends, employs generally accepted accounting concepts. Under § 500 a dividend can be paid if either (a) it is no more than the corporation's retained earnings or (b) after the dividend the assets (excluding certain intangibles) equal 1.25 times liabilities; and current assets at least equal current liabilities. Section 114, part of the definitional chapter, provides that "[a]ll references . . . to financial statements . . . assets, liabilities, earnings, retained earnings and similar accounting items . . . mean such financial statements or such items prepared or determined in accordance with generally accepted accounting principles then applicable, and fairly presenting the matters which they purport to present. . . ." For an extensive discussion of the provisions of the California statute see 23 U.C.L.A. L. REV. 1035-1332 (1976), and in particular Ackerman & Sterrett, *California's New Approach to Dividends and Reacquisition of Shares, Id.* at 1052.

Likewise, the North Carolina statute employs some accounting concepts. N.C. GEN. STAT. § 55-2(2) (1975 Repl. Vol.) defines "asset" as "those properties and rights, other than treasury shares, which in accordance with generally accepted accounting practice, are recognized as being properly entered upon the books and balance sheets of business enterprises in terms of a monetary value," and "earned surplus" is defined in N.C. GEN. STAT. § 55-49(d) (1975 Repl. Vol.) to expressly exclude gains from "unrealized appreciation." *See* Folk, *supra* note 58, at 839-45.

New York, as an aftermath to Randall v. Bailey, 288 N.Y. 280, 23 N.Y.S.2d 173, 43 N.E.2d 43 (1942), also excludes unrealized appreciation of assets from its definition of earned surplus. N.Y. BUS. CORP. LAW § 102(6) (Consol. 1976). *See* de Capriles & McAniff, *supra* note 81, at 1257-58. The authors state that the definition is not intended to overrule Randall v. Bailey since unrealized appreciation could be reflected in capital surplus and paid out in dividends from that source.

> [T]he intent seems to be to endorse the prevailing accounting practice of allocating earnings to the accounting period in which the revenue is realized; *i.e.*, converted into

payable to the holders of shares having prior or equal rights to the assets of the corporation on involuntary dissolution" is less susceptible of determination. Reference first must be made to the terms of the senior or equal ranking shares to determine the involuntary dissolution preference. Then a determination must be made from an interpretation of the contract language in the articles of incorporation and the applicable state law, as to whether any additional sums are payable with respect to the shares.[128]

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cash or equivalent. In this view, the objection to unrealized appreciation is a matter of timing; recognition of unrealized earnings or revenue in the earned surplus account is premature.

Id. at 1258.

The proposed revision to MODEL ACT § 45 allows the determination of the amount of any distribution to shareholders to be made on "(i) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, or (ii) a fair valuation or other method that is reasonable in the circumstances." Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions,* 34 BUS. LAW. 1867, 1872 (1979).

128. *See* APB OPINION 10, ¶ 10-11.01, *as amended (reprinted in* [1976] 3 ACCOUNTING PROFESSIONAL STANDARDS (CCH) AC § 5515). This provides that the amount of any liquidation preference should be disclosed in the aggregate in the equity section of the balance sheet and in the notes thereto; and ¶ 10-11.02(b) which provides that the aggregate and per share amounts of any cumulative dividend arrearage should be disclosed in the balance sheet or notes thereto.

Generally, the most important question would be whether there are accrued and unpaid dividends with respect to the shares payable upon involuntary liquidation either as a component of the liquidation preference or as an additional sum payable upon liquidation. The issue is one of interpretation of the provision in the articles of incorporation and the applicable state law. *See* Hay v. Hay, 38 Wash.2d 513, 230 P.2d 791 (1951) which holds that accrued and unpaid dividends shall be paid to preferred shareholders in liquidation, even though there was no legally available source from which they could have been paid as dividends during the life of the corporation. *Accord,* 12 W. FLETCHER, *supra* note 57, at § 5449; *contra,* Wouk v. Merin, 283 App. Div. 522, 128 N.Y.S.2d 727 (1954).

One way to draft around this problem would be to provide in the articles of incorporation that the liquidation preference of the shares shall be "an amount equal to the sum of (i) $ __ per share, plus (ii) an additional sum computed at the rate of $ __ [the amount of the annual dividend] per annum for the period from the date on which the shares were issued to the date of payment of the liquidation preference, minus all dividends paid or declared with respect to the shares." This makes the liquidation preference a combination of the principal sum, together with any premium, plus an additional sum computed to be equal to accrued and unpaid dividends. However, since the latter component is not a dividend, but an amount computed by reference to accrued and unpaid dividends, the issue of whether the distribution includes unauthorized dividends does not arise. *See* Buxbaum, *supra* note 2, at 258.

The North Carolina statute also partially resolves this issue. It prohibits purchase or redemption of shares if there exist any unpaid accrued dividends on preferred shares of a prior class. N.C. GEN. STAT. § 55-52 (1975 Repl. Vol.). *See* Folk, *supra* note 58, at 837.

A similar issue exists regarding the redemption price. Can stated capital be invaded to

The net asset limitation presents the same issue as the insolvency limitation regarding the time of its application, the time the transaction is entered into or the time of payment.[129]

The net asset limitation does provide some additional protection to the creditors. The amount of the net assets which is unavailable for future redemptions or purchases (the amount equal to that payable to the senior or equal rank shares on dissolution) would be used to pay the creditors before any liquidation preferences are paid to the senior shareholders.[130] The limitation, of course, prevents the corporation from favoring some of its senior shareholders at the possible expense of others by protecting the dissolution preference of all senior and equal rank shares.

However, the protection afforded both the creditors and senior shareholders by this section may be ephemeral in certain circumstances. The amount of the net assets necessary to make the dissolution distribution is not permanently attributed to the shares as a part of stated capital. This aggregate amount may be in excess of the stated capital represented by the senior or equal rank shares, because the aggregate dissolution distribution may include a premium or accrued and unpaid dividends. The excess in this aggregate amount over the stated capital of the senior or equal rank shares would be reflected in earned or capital surplus. The amount reflected in earned surplus would be available generally for divi-

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pay the full redemption price if a portion of the price includes accrued and unpaid dividends? Dividends clearly cannot be paid from stated capital.

N.Y. BUS. CORP. LAW § 513(d) (McKinney 1976) expressly states that the amount payable upon redemption of shares having cumulative dividend preference "may include the stated redemption price plus accrued dividends to the next dividend date following the date of redemption of such shares."

129. In Mountain State Steel Foundaries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), the Court of Appeals construed W.VA. CODE ANN. § 3051, which prohibited a corporation from repurchasing its shares when to do so would cause an impairment of capital, to mean that each installment of the payment was to be tested against the statute, and not that the entire purchase price be at least equal to surplus at the outset. This holding is similar to that in Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935), regarding the insolvency limitation. Professor Herwitz demonstrates some of the accounting difficulties caused by the application of the surplus or non-impairment of capital test on an installment-by-installment basis. Some of his questions are similar to the issues raised by the opinion in Williams v. Nevelow, 513 S.W.2d 535 (Tex. 1974), *e.g.*, whether surplus is to be restricted at the outset by the full price paid for the shares, or only by the amount of each installment, and, if the latter, where is the offsetting entry to the value of the shares, as treasury shares. Herwitz, *supra* note 113, at 313-23.

130. Kessler, *supra* note 79, at 653-56.

dends or share repurchases pursuant to Model Act section 6. Although the net asset limitation may prohibit further redemptions or purchases of redeemable shares, thereby protecting creditors and senior or equal ranking shares, it does not preclude the use of part of this sum for the benefit of junior shareholders through dividends or other share repurchases.[131]

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131. This situation exists when the involuntary dissolution preference is high in relation to the par value of the redeemable shares. Assume a corporation has a capital structure consisting of 20 shares of preferred stock par value and issue price $100, involuntary dissolution preference of $140 (because of a liquidation or redemption premium or accrued and unpaid dividends), and 100 shares common stock, par value $ .10 issue price $2.00, and the following balance sheet:

Assets	Liabilities	
$13,200	$10,000	
	2,000	stated capital, preferred shares
	10	stated capital, common shares
	190	paid in surplus, common shares
	2,200	
	1,000	earned surplus
$13,200	$13,200	

If 10 of the preferred shares were purchased or redeemed at $140 each, the net assets after the transaction would be $1,800 (assets after the transaction, $11,800 minus liabilities, $10,000). Stated capital before the transaction was $2,010; after the reduction in capital by the amount represented by the reacquired shares it would be $1,010. It is not important whether the $1,400 necessary to effect the transaction was taken entirely from stated capital or partly from earned surplus and stated capital. After the reduction in capital pursuant to MODEL ACT § 67 the stated capital would be reduced by the $1,000 representing the par value of the redeemed or repurchased shares and earned surplus would be charged with the remaining $400. *See* notes 96-105, 136 and accompanying text. The transaction would meet the net asset limitation of § 66 because after the transaction net assets ($1,800) exceed the involuntary dissolution preference.

After the transaction and the reduction in capital, earned surplus and capital surplus would be $600 and $190, respectively. If the $600 earned surplus were then paid out to the junior shareholders by way of dividend, net assets would become $1,200 (assets after the dividend, $11,200 minus liabilities, $10,000). This is an insufficient amount to pay the remaining preferred shares their involuntary dissolution preference of $1,400.

MODEL ACT § 46(d) would restrict the use of capital surplus as a dividend source in this situation. It provides that no distribution be made from capital surplus which would reduce the remaining net assets (after the distribution) "below the aggregate preferential amount payable in the event of involuntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the writ of liquidation." There is, however, no comparable provision regarding the use of earned surplus. The Act would not require that earned surplus be "restricted" (and thus be unavailable pursuant to § 45(a) as a source of dividends) in the amount of the involuntary dissolution preference. Section 70 authorizes the

The net asset test as stated in section 66 does allow the stated capital of the junior shares to be virtually eliminated through redemption of senior shares. This is a consequence of the right to invade completely stated capital to effect a redemption or purchase authorized by section 6. However, this anomaly exists only for the short period of time between the conclusion of the transaction and the reduction of capital, as provided in section 67.[132] This approach is not followed in all states. New Jersey, for example, limits the right to invade stated capital. Under its statute stated capital may be used as a source to effect redemption, but it can be used only to the extent that after the redemption net assets at least equal the stated capital of the remaining shares.[133] This scheme imposes the

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board of directors to establish reserves from earned surplus for any proper purpose, likewise making the amount so reserved unavailable for dividends. However this section does not require that reserves be set aside.

In the more usual situation in which the amount paid by the corporation for the shares is close to the issue price, the net asset limitation fully protects the remaining preferred shares. If in the example stated above the amount of the involuntary liquidation preference and the amount paid for the shares was $105, earned surplus would be $950 after the purchase of the 10 shares and the reduction in capital. If this were paid out to the junior shareholders, net assets would become $1,200, an amount in excess of the aggregate involuntary dissolution preference of the remaining 10 preferred shares, $1,050.

132. In the example stated in note 131 *supra,* if the redemption price was $100.50 and all 20 shares of preferred were redeemed from stated capital at that price, the full amount thereof, $2,010, would be used even though $10 of it represented the stated capital of the common shares. Upon reduction of capital as provided in § 67, stated capital of $10 would be restored (capital being reduced by the stated capital representing the redeemed shares, $2,000) and the remaining $10 of the purchase price would be charged to earned surplus.

The net asset limitation does not apply only when stated capital is used as the source for the reacquisition. Since net assets mean assets minus liabilities, the amount of net assets can be reflected in stated capital, capital surplus or earned surplus. The test is met if net assets from any or all of these catagories at least equals the aggregate involuntary dissolution preferences. However, because of the reduction in capital provisions of § 67, the amount necessary to effect the reacquisition will largely be reflected in the change in stated capital.

133. N.J. STAT. ANN. § 14A:7-16(3) (West 1969) ("A corporation may redeem or purchase its redeemable shares out of stated capital, except when after such redemption or purchase net assets would be less than the stated capital remaining after giving effect to the cancellation of such shares."). The stated capital is deemed to be reduced upon the cancellation of the redeemed shares, N.J. STAT. ANN. § 14A:7-18(3) (West 1969), and the use of stated capital as a source for the reacquisition of redeemable shares effects the cancellation of the shares. N.J. STAT. ANN. § 14A:7-18(1) (West 1969). *See also* N.Y. BUS. CORP. LAW § 513(c) (McKinney 1976) which states:

> A corporation, subject to any restrictions contained in its certificate of incorporation, may redeem or purchase its redeemable shares out of stated capital except when currently the corporation is insolvent or would thereby be made insolvent and except when such redemption or purchase would reduce net assets below the stated capital remaining after giving effect to the cancellation of such redeemable shares.

net asset limitation against the stated capital of the remaining shares—of a higher, equal or junior rank. The Model Act approach allows the complete invasion of stated capital; and it applies the net asset limitation, thereby restricting further redemptions or purchases, against involuntary dissolution, an event that may never occur.[134]

The consequence, as provided in section 67, of a redemption or purchase of redeemable shares, regardless of the price paid, is the immediate cancellation of the shares, followed by the reduction in stated capital of the amount represented by such shares. The stated capital represented by the shares cancelled is defined in the Model Act to be a par value, or stated value of the shares plus any amounts added thereto.[135] The redemption price or the price at

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134. The difference between the two approaches is most apparent when there is little surplus.

Assume a corporation has a capital structure consisting of 20 shares of preferred stock par value and issue price $100, redemption price and involuntary dissolution preference of $105 and 100 shares of common stock par value $2, issue price $2, and the following balance sheet:

Assets	Liabilities	
$12,200	$10,000	
	2,000	stated capital, preferred shares
	200	stated capital, common shares
	0	paid in surplus
	2,200	
	0	earned surplus
$12,200	$12,200	

The corporation wishes to redeem 10 of the shares at the redemption price of $105. The aggregate purchase price would be $1,050. Under the MODEL ACT approach the transaction would be authorized since the net assets after the transaction would be $1150 (assets $11,150 minus liabilities $10,000) and the involuntary dissolution preference of the remaining preferred shares is $1,050. Under the New Jersey approach the transaction would not be authorized. The stated capital represented by the remaining shares would be $1000 for the preferred and $200 for the common. Net assets after the redemption, $1150, would not at least equal the state capital of the remaining shares, $1200. The difference is caused by the fact that under the MODEL ACT the stated capital represented by the junior shares can be invaded, whereas under the New Jersey approach this cannot be done.

135. MODEL ACT § 2(j) defines stated capital to be the sum of (i) par times shares issued, (ii) the consideration received for no par shares, less that portion thereof allocated to capital surplus as authorized by the statute, times the shares issued and (iii) such amounts as are transferred thereto subtracted therefrom as provided by the statute. Section 21 allows the

which redeemable shares are purchased will probably be different from the stated capital. The redemption price may be greater because it may contain a slight premium over the par (which would typically be the issue price, particularly for preferred) or any accrued and unpaid dividends. A purchase price, likewise, may vary from the redemption price and the stated capital represented. It may be less since the redemption date may be years in the future. Regardless of the purchase or redemption price, the stated capital will be reduced pursuant to section 67 by the full amount of the stated capital represented by the redeemed or repurchased shares.

If the redemption or purchase price exceeds the stated capital represented by those shares, the stated capital representing junior shares may be used to effect the redemption or purchase. However, upon the reduction in capital, any excess in the purchase price over the stated capital of the redeemed or purchased shares will be charged against earned surplus or capital surplus.[136] If, on the other

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directors to transfer sums from surplus to stated capital. The board may designate such sums as being stated capital with respect to a specific class of shares.

136. The MODEL ACT does not state which sources of funds should be charged for this premium over stated capital. However, accounting convention would indicate that the charge generally be made to earned surplus, not capital surplus. ARB 43, ch. 1B, ¶ 13(a)(i) *as amended (reprinted in* [1976] 3 Accounting Professional Standards (CCH) AC § 5542) states that

> [w]hen a corporation's stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws; i. *an excess of purchase price over par or stated value* may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net "gains" on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.

See DAVIDSON & WEIL, *supra* note 10, at 28-12. In the example stated in note 131 if the redemption price was $100.50 per share and all 20 redeemable shares were redeemed or purchased at that price from stated capital, the aggregate payment, $2,010, would be the entire amount of stated capital. Upon reduction of capital as provided in § 67, $2000 representing the par value and the stated capital of the redeemed shares would be charged to stated capital, resulting in a stated capital of $10, that represented by the common shares. Earned surplus would be reduced by $10, the aggregate redemption price premium over the stated capital represented by the redeemed shares.

Concern has been expressed over the general working of the restriction on earned surplus when used as the source of share purchase, and the lifting of the restriction when the shares

hand, the redemption or purchase price is less than the stated capital represented by the shares, a surplus will be created upon reduction by the full amount of stated capital represented by the reacquired shares. Under the terms of the Model Act, section 70, such surplus will be considered capital surplus.[137]

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are cancelled. The concern is that a relatively small amount of earned surplus can be used over and over to support the repurchase and cancellation of a large total dollar value of shares. *See* Hackney *supra* note 10, at 1396; Rudolf, *Accounting for Treasury Shares Under the Model Business Corporation Act*, 73 HARV. L. REV. 323, 328 (1959). There is even greater reason for concern in the context of redemption or purchase of redeemable shares from earned surplus.

If the $2,010 price were paid, $1000 from earned surplus and $1010 from stated capital, the result, upon reduction of capital, would be the same as previously stated: stated capital would be reduced to $10, and earned surplus would be reduced by $10 to $990. However, between the time the purchase or redemption is concluded and the filing of this statement of reduction by the secretary of state, earned surplus, which was $1,000, is not even restricted. Section 6 provides that earned surplus is restricted so long as the shares are held as treasury shares. However, by definition treasury shares do not include cancelled shares; and the redeemed or purchased redeemable shares are by § 67 immediately cancelled. Hence the full $1000 would appear to be available as a source of dividends or share repurchases, although, after the reduction in capital, earned surplus would be reduced to $990. *See* note 102 *supra*.

MODEL ACT § 70 provides in part that "[t]he surplus, *if any*, created by or arising out of a reduction of the stated capital of a corporation shall be capital surplus." (emphasis added). Professor Herwitz maintains that, when earned surplus is used as the source of purchase of treasury shares and the shares are subsequently cancelled, §§ 6 and 70 of the MODEL ACT are in conflict. Section 6 would restrict earned surplus by the amount of the purchase price so long as the shares are held as treasury shares, and upon the cancellation of the shares the restriction would be removed. Whereas § 70 would require that upon the cancellation of the shares and reduction of surplus, the amount of the price be transferred from earned to capital surplus. D. HERWITZ, BUSINESS PLANNING, 425-26 (1966). (He refers to §§ 5 and 64 of the MODEL ACT, the provisions in the 1966 version of the MODEL ACT analogous to the present §§ 6 and 70, respectively.) Fiflis and Kripke point out that when treasury shares purchased with earned surplus are cancelled, there is no surplus created and thus § 70 is inapplicable. Instead, the restriction on earned surplus in the amount of the purchase price, which was imposed at the time of the purchase and was in effect while the shares were held as treasury shares, is lifted. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS, 392-93 (2d ed. 1977).

The argument that § 70 is not applicable in the context of a redemption or a purchase of redeemable shares from earned surplus is even stronger. There is not even a restriction on earned surplus since the shares are immediately cancelled.

Paragraph 14 of ARB 43, ch. 1B states that some state statutes prescribe the accounting treatment for reacquired shares. "Where such requirements are at variance with paragraph 13 the accounting should conform to the applicable law." (ARB 43, ch. 1B ¶ 14, *as amended by* APB Opinion No. 6). However, MODEL ACT §§ 6 and 70 can be construed to be consistent with one another, as Fiflis and Kripke point out. Hence, the MODEL ACT would appear not to require an alternative accounting treatment as would be authorized by paragraph 14.

137. Again the MODEL ACT is silent on this point. ARB 43, ch. 1B, ¶ 13(a)(ii) *as amended by* Opinion No. 6, states: "an excess of par or stated value over purchase price should be credited to capital surplus." *See* DAVIDSON & WEIL, *supra* note 10, at 28-12.

III. Virginia Statutory Provisions

The provisions of the Virginia Stock Corporation Act regarding share redemptions are patterned upon the Model Act. Accordingly the preceding discussion of the Model Act provisions is either applicable to the Virginia enactment or, where indicated, serves as a basis for analysis of the differences. The Virginia enactment, however, differs from the Model Act in one very significant point, the disposition of the redeemed or reacquired shares.

The Virginia statute breaks the provisions of section 15 into two sections which authorize the creation and issuance of redeemable shares. Section 13.1-12[138] restates, with little change, the first paragraph of section 15. Section 13.1-13,[139] like the second paragraph of

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Thus, in the example stated in note 131, if the 20 preferred shares were purchased at $99 per share (total purchase price of $1980) from stated capital, or a combination of stated capital and earned surplus, stated capital, upon the reduction of capital, would again be reduced by $2000, the stated capital represented by the purchased shares. A separate entry in the capital surplus account would be made for the remaining $20.

In this example, a surplus of $20 is created upon the reduction in capital. Since the reduction in stated capital is greater than the purchase price, the language of Model Act § 70 that "[t]he surplus, *if any*, created by or arising out of a reduction of the stated capital of a corporation shall be capital surplus" (emphasis added) clearly requires that the $20 be treated as capital surplus since it is created by or arises out of a reduction of stated capital. The accounting convention is consistent with § 70.

138. Each corporation shall have power to create and issue the number of shares stated in its articles of incorporation. Such shares may be divided into one or more classes. Any or all of such classes may consist of shares with par value or shares without par value, with such designations, preferences, limitations, and relative rights as shall be stated in the articles of incorporation, except that shares without par value shall not be issued by banking corporations, building and loan associations, credit unions or industrial loan associations. The articles of incorporation may limit or deny the voting rights of or provide special voting rights for the shares of any class to the extent not inconsistent with the provisions of this Act.

Va. Code Ann. § 13.1-12 (1978 Repl. Vol.).

139. Without limiting the authority hereinabove contained, a corporation, when so provided in its articles of incorporation, may issue shares of preferred or special classes:

(a) Subject to the right of the corporation to redeem any of such shares at the prices fixed by the articles of incorporation for the redemption thereof.

(b) Entitling the holders thereof to cumulative, non-cumulative or partially cumulative dividends.

(c) Having preference over any other class or classes of shares as to the payment of dividends.

(d) Having preference in the assets of the corporation over any other class or classes of shares upon the voluntary or involuntary liquidation of the corporation.

(e) Convertible into shares of any other class or into shares of any series of the same or any other class, except a class having prior or superior rights and preferences as to dividends or distribution of assets upon liquidation.

(f) Entitled to voting rights or participating rights or any other special rights that may be specified, including a right that no transaction of specified nature shall be consummated while any such shares remain outstanding in any event or except upon the assent of a specified proportion of such shares.

VA. CODE ANN. § 13.1-13 (1978 Repl. Vol.).

Subpart (a) regarding redemption is identical to the language in § 15, except that it uses the plural "redeem . . . at the prices fixed by the articles . . ." whereas § 15 uses the singular. Subparts (b), (c) and (d) are identical to their counterparts in § 15. Subpart (e) is identical to its counterpart except that it does not include the provision in MODEL ACT § 15(e) limiting the conversion of no par shares into par value shares. There is no counterpart to subpart (f) in § 15. VA. CODE ANN. § 13.1-14 (1978 Repl. Vol.), the analog to MODEL ACT § 16, provides for the issuance of preferred or special classes of shares in series.

If the articles of incorporation so provide, the shares of any preferred or special class may be divided into and issued in series. If the shares of any such class are to be issued in series, then each series shall be so designated as to distinguish the shares thereof from the shares of all other series and classes. Any or all of the series of any such class and the variations in the relative rights and preferences as between different series may be fixed and determined by the articles of incorporation, but all shares of the same class shall be identical except as to the following relative rights and preferences, as to which there may be variations between different series:

(a) The rate of dividend, the time of payment and the dates from which dividends shall be cumulative, and the extent of participation rights, if any.

(b) Any right to vote with holders of shares of any other series or class and any right to vote as a class, either generally or as a condition to specified corporate action.

(c) The price at and the terms and conditions on which shares may be redeemed.

(d) The amount payable upon shares in event of involuntary liquidation.

(e) The amount payable upon shares in event of voluntary liquidation.

(f) Sinking fund provisions for the redemption or purchases of shares.

(g) The terms and conditions on which shares may be converted, if the shares of any series are issued with the privilege of conversion.

If the articles of incorporation shall expressly vest authority in the board of directors, then, to the extent that the articles of incorporation shall not have established series and fixed and determined the variations in the relative rights and preferences as between series, the board of directors shall have authority to divide any or all such classes into series and, within the limitations set forth in this section and in the articles of incorporation, fix and determine the relative rights and preferences of the shares of any series so established.

In order for the board of directors to establish a series, where authority so to do is contained in the articles of incorporation, the board of directors shall adopt a resolution setting forth the designation and number of shares of the series and the relative rights and preferences thereof, to the extent that variations are permitted by the articles of incorporation.

Prior to the issuance of any shares of a series so established, the corporation shall file in the office of the Commission articles of serial designation setting forth:

(i) The name of the corporation.

(ii) The resolution of the board of directors.

(iii) The date of its adoption.

(iv) That it was duly adopted by the board of directors.

The articles shall be executed by the corporation by the chairman or vice-chairman of its board of directors or its president or a vice-president and by its secretary or an assistant secretary and delivered to the Commission. If the Commission finds that the articles comply with the requirements of law and that all required fees have been

section 15, contains the grant of authority to issue shares of preferred or special classes. Its provision regarding redemption in subsection (a) is virtually identical to the Model Act language. The introductory phrase to section 13.1-13 states "[W]ithout limiting the authority hereinabove contained." While the word "hereinabove" is not a precise reference to the section's intended antecedant, it clearly refers to the general grant of authority to create and issue shares contained in section 13.1-12. This is particularly so since the two sections are largely enactments of the first and second paragraphs of Model Act section 15, of which the introductory phrase to the second paragraph reads "[W]ithout limiting the authority herein contained." With this qualification the preceding comments regarding Model Act section 15 are applicable to sections 13.1-12 and 13.1-13.

Section 13.1-4[140] authorizes the reacquisition of shares from

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paid, it shall by order issue a certificate of serial designation, which shall be admitted to record in its office. Upon the completion of such recordation, the Commission shall forward the certificate for recordation in the office for the recording of deeds in the city or county in which the registered office of the corporation is located, except that no such further recordation shall be required in the city of Richmond or the county of Henrico. Upon the completion of such further recordation, the certificate shall be returned to the Commission by registered or certified mail. Upon the issuance of such certificate, it shall become effective in accordance with its terms.

Unless the articles of incorporation otherwise provide, the board of directors may redesignate any shares of any series theretofore established that have not been issued, or that have been issued and retired, as shares of some other series or change the designation of outstanding shares where desired to prevent confusion. Such redesignation or change of designation shall be set forth in articles of serial designation.

VA. CODE ANN. § 13.1 (1978 Repl. Vol.).

The introductory clause is identical to MODEL ACT § 16; subpart (c) dealing with redemption is substantively the same as MODEL ACT § 16(b). The remainder of this section, like MODEL ACT § 16, authorizes the board of directors to divide the classes into series and to fix and determine the relative rights and preferences of various series. However, unlike § 16, it does not expressly state that the certificate of serial designation constitutes an amendment to the articles of incorporation.

140. A corporation shall have the right to purchase, take, receive or otherwise acquire, hold, own, pledge, transfer or otherwise dispose of its own stock, but, [except in the case of open-end investment trusts] purchases of its own stock, whether direct or indirect, shall be made only to the extent of earned surplus available therefor or capital surplus. To the extent that earned surplus or capital surplus is used as the measure of a corporation's right to repurchase its own stock, to that extent such surplus shall be restricted so long as such stock is held as treasury shares, but upon the disposition or cancellation of any such stock the restriction shall terminate. [Restricted surplus shall not be available for the repurchase of shares or other distributions on shares. The right to repurchase may be limited or denied by express provision of the articles of incorporation.]

earned or capital surplus, substantially on the same terms as section 6 of the Model Act. It authorizes the invasion of stated capital to effect the retirement of its redeemable shares either through redemption or purchase at not to exceed the redemption price. The last paragraph of the section contains the general insolvency limitation on share reacquisitions. However, unlike Model Act section 6, the insolvency limitation of section 13.1-4 applies only to the "purchase" by a corporation of its own shares. It does not contain the

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> Notwithstanding the foregoing limitations, a corporation may purchase or otherwise acquire its own stock in the course of:
>
> (1) Effecting, subject to the other provisions of this Act, the retirement of its redeemable stock by redemption or by purchase at not to exceed the redemption price.
>
> (2) Collecting or compromising indebtedness to the corporation.
>
> (3) Paying dissenting stockholders entitled to payment for their shares under the provisions of this Act.
>
> But in no case shall any purchase of its own stock be made at a time when the corporation is insolvent or when such purchase would render it insolvent.

VA. CODE ANN. § 13.1-4 (1978 Repl. Vol.) (brackets aded). The material in brackets is not in MODEL ACT § 6. This section does not provide, as does MODEL ACT § 6, that purchases be only from "unreserved or unrestricted" earned or capital surplus. This is not a significant difference since the section contains the sentence, as in § 6, to the effect that earned or capital surplus, if used as the measure of the purchase price shall be restricted. The section then expands on this by stating the effect of a restriction on surplus, *i.e.*, that it is unavailable, to the extent of the restriction, for distribution to the shareholders as a dividend or through share repurchase.

Also, the section does not provide, as does § 6, that capital surplus is available only if the articles of incorporation so provide or if the use is approved by the affirmative vote of a majority of the shares. One could argue that this provision in § 6 is surplusage since MODEL ACT § 46 authorizes a distribution of assets out of capital surplus, only if "(b) the articles of incorporation so provide or such distribution is authorized by the affirmative vote of the holders of a majority of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of the articles of incorporation of the corporation." MODEL ACT § 46. Section 46 is not limited to dividend distribution, but applies to distributions generally.

The Virginia statute does not contain a provision analogous to MODEL ACT § 46. Instead, capital surplus is made an alternative source for dividends in the dividend section. VA. CODE ANN. § 13.1-43 (1979 Supp.). That section merely provides that a dividend paid from capital surplus be "identified as a distribution of capital surplus and the amount per share paid from such surplus shall be disclosed to the stockholders receiving the same concurrently with the distribution." There is no requirement in § 13.1-43(a), as there is in § 46 of the MODEL ACT, that authority to use capital surplus be expressly stated in the articles of incorporation or conferred by the affirmative vote of shareholders. *See,* Emerson, *supra* note 1, at 502-05. The only requirement is that the shareholders be advised that the dividend is being paid from capital surplus.

Section 13.1-4 treats earned or capital surplus as alternative sources of share repurchase. It appears not even to require the notice to shareholders that capital surplus is the source, as § 13.1-43(a) would require in the instance of a dividend distribution, to say nothing of the express authority either by provision in the articles of incorporation or shareholder approval which MODEL ACT § 6 requires.

"purchase or payment" language of section 6. The rationale of the *Williams* case, to the effect that the insolvency restriction with respect to installment purchases applies at the time the transaction is entered into and not at the time of payment, would be more pertinent to a purchase of redeemable shares under the Virginia statute than under the Model Act itself. Under the Model Act there are two insolvency provisions, one of which applies to any purchase or payment, section 6, the other of which applies only to purchases, section 66.[141] Whereas, under the Virginia statutory scheme the insolvency tests in sections 13.1-4 and 13.1-62 apply only to purchases.

Section 13.1-62[142] is the analog of Model Act section 66, and is identical thereto.

The significant difference between the Virginia provisions and the Model Act are contained in sections 13.1-63[143] and 13.1-66.[144]

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141. *See* notes 113-16 *supra*, and accompanying text.

142. No redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such redemption or purchase would render it insolvent, or which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

VA. CODE ANN. § 13.62 (1978 Repl. Vol.).

143. The corporation, by resolution of its board of directors, may provide for the cancellation of shares that it has issued and purchased, redeemed or otherwise reacquired. The resolution shall designate the shares that are to be cancelled, may provide for the reduction of stated capital in an amount equal to all or any part of the amount of stated capital represented by the shares to be cancelled, and shall show the amount expressed in dollars, of the stated capital as it is to be after the cancellation. Shares reacquired in conversion or exchange may be cancelled, and capital may be reduced in respect thereof to the extent that the stated capital represented by such shares exceeds the aggregate par value of shares into which such shares were converted or for which such shares were exchanged or to the extent of the entire stated capital represented by such shares if such shares have been converted into or exchanged for securities or obligations other than shares of stock. In the case of a conversion of shares into, or an exchange of shares for, shares having no par value, no reduction of capital may be made in respect thereof pursuant to this section.

Articles of reduction shall be executed by the corporation by the chairman or a vice-chairman of its board of directors or its president or a vice-president and by its secretary or an assistant secretary. They shall show:

(a) The name of the corporation.

(b) A copy of the resolution of the board of directors, and the date of its adoption.

(c) The aggregate number of issued shares, itemized by classes and series, after giving effect to such cancellation.

(d) If the articles of incorporation provide that the cancelled shares shall not be reissued, then the number of shares, itemized by classes and series, which the corpo-

These sections in total contrast to the Model Act provide for an optional, not automatic cancellation of redeemed or purchased redeemable shares, and for a reduction of stated capital in any amount up to that represented by the cancelled shares.

Section 13.1-63 provides in part that

> [a] corporation, by resolution of its board of directors, may provide for the cancellation of shares that it has issued and purchased, redeemed or otherwise reacquired. The resolution shall designate the shares that are to be cancelled, may provide for the reduction of capital in an amount equal to all or any part of the amount of stated capital represented by the shares to be cancelled. . . .

Section 13.1-66 provides that upon issuance of the certificates of reduction by the State Corporation Commission, "[t]he capital

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ration will have authority to issue after giving effect to such cancellation.

VA. CODE ANN. § 13.1-63 (1978 Repl. Vol.).

144. Upon the issuance of a certificate of reduction by the Commission, the stated capital shall be reduced by the amount specified in the articles of reduction and any cancellation of shares therein provided for shall become effective, except as to shares subsequently to be reacquired.

Cancelled shares shall, unless the articles of incorporation provide that they shall not be reissued, become authorized and unissued shares of the same class but undesignated as to series. If the articles of incorporation provide that such shares shall not be reissued, the issuance of the certificate of reduction shall reduce the number of shares of that class which the corporation is authorized to issue by the number of shares so cancelled.

VA. CODE ANN. § 13.1-66 (1978 Repl. Vol.)

Additionally, § 13-1.65 provides:

> The articles of reduction executed pursuant to § 13.1-63 or §13.1-64 shall be delivered to the [State Corporation] Commission. If the Commission finds that the articles comply with the requirements of law and that all required fees have been paid, it shall by order issue a certificate of reduction, which shall be admitted to record in its office. Upon the completion of such recordation, the Commission shall forward the certificate for recordation in the office for the recording of deeds in the city or county in which the registered office of the corporation is located, except that no such further recordation shall be required in the city of Richmond or the county of Henrico. Upon the completion of such further recordation, the certificate shall be returned to the Commission by registered or certified mail.

VA. CODE ANN. § 13.1-65 (1978 Repl. Vol.).

Section 13.1-18 similarly provides in part that "stated capital shall not be decreased or otherwise affected by the purchase or redemption of stock unless a certificate of reduction be issued by the Commission. . . ." VA. CODE ANN. § 13.1-18 (1978 Repl. Vol.).

Sections 13.1-65 and 13.1-66 contain provisions analogous to the latter portion of MODEL ACT § 67 dealing with the review of the articles of reduction and the consequence of the filing of the certificate of reduction.

shall be reduced by the amount specified in the articles of reduction and any cancellation of shares therein provided for shall become effective. . . ." Therefore, unlike section 67 the redeemed or repurchased redeemable shares are not cancelled upon their reacquisition. They are cancelled only upon the issuance of the certificate of reduction. At its option, the board of directors may pass a resolution approving a cancellation of the stock and a reduction of capital. It is, however, under no obligation to do so. Section 67 is different in that it requires the appropriate officer to execute the statement of cancellation and deliver it to the secretary of state, which when filed effects a cancellation of the shares and reduction of capital by the amount represented by the cancelled shares.

This permissive cancellation approach makes critical an aspect of section 13.1-4 which is of less importance under its analog, Model Act section 6. Both provisions authorize the invasion of stated capital to effect "the retirement of its redeemable stock by redemption or by purchases at not to exceed the redemption price."[145] However, section 13.1-4 does not appear to authorize use of stated capital to redeem or purchase redeemable shares unless the board of directors intended to cancel the shares, thereby effecting their retirement.[146] Whereas under the Model Act scheme, stated capital can be used to effect any redemption or purchase of redeemable shares, since the shares are automatically cancelled on reacquisition.

Under the Virginia scheme, if the redeemed or repurchased redeemable shares are not cancelled, they would be considered treasury shares.[147] Presumably, the reacquisition of such shares without

145. VA. CODE ANN. § 13.1-4(1) (1978 Repl. Vol.). MODEL ACT § 6(d) is identical.

146. Like the MODEL ACT, the Virginia statute does not define the term "retirement." However, the term is considered to mean cancellation, especially when used in connection with senior shares. 11 W. FLETCHER, *supra* note 17, at § 5308.

It is likely that the board of directors would retire shares redeemed on the terms contained in the articles of incorporation. However, when redeemable shares are purchased, it is possible that the board of directors would consider their resale, particularly if the purchase was at less than the redemption price, and a future sale could be made at the redemption price. Of course, under the MODEL ACT the shares could also be sold again as newly issued shares. Section 67 provides that the cancelled shares be restored to the status of authorized but unissued shares, unless the articles provide that they not be reissued. The Virginia scheme would allow the shares to be resold as treasury shares. This distinction would be important under the MODEL ACT since par value shares must be issued for at least par value. MODEL ACT § 18. Virginia, however, does not have such a restriction.

147. VA. CODE ANN. § 13.1-2(f) (1978 Repl. Vol.) defines treasury shares as "shares of a

cancellation would be allowed by the general authorization of share reacquisition language of section 13.1-4, if earned or capital surplus were the source used. Such fund would, of course, be restricted by the amount of the purchase price.[148]

The difficulty with section 13.1-4 is that its provisions regarding redemption are virtually identical to section 6 of the Model Act. There is a strong temptation to conclude that the effect of this language is the same. However, since the Virginia statute does not follow the Model Act's scheme with respect to the cancellation of the redeemed or repurchased redeemable shares, the operation of section 13.1-4 cannot be equated with that of section 6 of the Model Act.[149]

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corporation which have been issued, have been subsequently reacquired and belong to the corporation and have not been effectively cancelled by the issuance of a certificate of reduction by the [Corporation] Commissioner."

148. VA. CODE ANN. § 13.1-43(a) (1979 Cum. Supp.), in authorizing the use of earned or capital surplus as the sources of dividends, provides that the dividend be declared and paid out of "unreserved and unrestricted earned surplus of the corporation or out of capital surplus of the corporation." Although it is presumably intended that the words "unreserved and unrestricted" modify both earned surplus and capital surplus, because of their position in the clause and because of the inclusion of the phrase "of the corporation" between earned surplus and capital surplus, it could be argued that the statute literally authorizes the declaration and payment of a dividend from any capital surplus, unrestricted or restricted. However, if capital surplus was restricted because it was used to purchase treasury shares, such capital surplus would clearly not be available as a source of dividend. Section 13.1-4, the section authorizing the repurchase of shares, provides that "[r]estricted surplus shall not be available for the repurchase of shares *or other distribution on shares.*"

149. In fact the permissive cancellation feature, VA. CODE ANN. § 13.1-63 (1978 Repl. Vol.), which provides that the board of directors *may* cancel any repurchased shares, including redeemable shares, is not unlike the Delaware provision. DEL. CODE ANN. tit. 8 § 243(a) (1974) provides that

> [a] corporation, by resolution of its board of directors, may retire any shares of its capital stock that are issued but are not outstanding. If a corporation acquires any of its shares, whether by purchase or redemption or by their having been converted into or exchanged for other shares of the corporation, and capital, as computed in accordance with §§ 154, 242 and 244 of this title, is applied in connection with such acquisition, the shares so acquired, upon their acquisition and without other action by the corporation, shall have the status of retired shares.

This section likewise allows, but does not require, the cancellation of any reacquired shares, including redeemed or repurchased redeemable shares. It provides, however, that if "capital," which is analogous to stated capital in the MODEL ACT scheme, is used in connection with the reacquisition, then the shares are automatically cancelled. The Virginia statute would operate in the same manner. Although redeemed or reacquired redeemable shares would not be cancelled by virtue of the use of stated capital to effect their reacquisition, stated capital could not be used unless the board of directors adopted the resolution providing for cancellation and reduction of capital pursuant to § 13.1-63 and filed the articles of reduction pursuant to § 13.1-65.

Section 13.1-63 authorizes the board of directors to determine the amount by which stated capital will be reduced upon cancellation up to the amount thereof represented by the reacquired shares. Presumably, this implies that the board could reduce capital by no amount, the full amount represented by the shares or by any amount in between these extremes.[150] Thus the board has the ability to maintain the amount of the cushion available to creditors, but at the expense of the junior shareholders. To the extent that capital is not reduced the redemption or purchase price will be charged against earned or capital surplus, effecting a reduction of the source of future dividend payment or other distribution.[151] This provision also is in contrast to Model Act section 67 which explicitly provides for reduction of capital in the full amount represented by the cancelled shares.

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150. If stated capital is not reduced by the full amount represented by the cancelled shares, the difference between the full amount and the amount of the reduction would be stated capital unassigned to any shares, since the shares which it represented have been cancelled. Both VA. CODE ANN. § 13.1-18 (1978 Repl. Vol.) and MODEL ACT § 21 apparently allow undesignated stated capital. Both of these sections authorize the directors to transfer a portion of the corporation's surplus to stated capital, and provide that "[t]he board of directors *may* direct that the amount of the surplus so transferred shall be deemed to be stated capital in respect of any designated class of shares." (Emphasis added). This sentence implies that the board may also not designate the surplus to a class of shares.

151. On the facts of the example stated in note 131 *supra*, if the 20 redeemable, preferred shares were redeemed or repurchased at $100.50 each, the total cost would be $2,010. VA. CODE ANN. § 13.1-63 (1978 Repl. Vol.) would authorize the board of directors to reduce capital by any amount up to $2000, the stated capital represented by the redeemed shares. The $10 premium over the stated capital represented by the shares would reduce earned surplus. If capital were reduced by $1000, the total stated capital would be $1010, even though the corporation's capitalization consists of only 100 common shares par value $10. The remaining $1000 (the $10 premium having been charged to earned surplus) would be charged to the remaining earned surplus of $990, wiping it out. The final $10 alternatively would create a deficit of $10 in earned surplus, or could be charged against capital surplus.

If the purchase price was $99 per share, the board could reduce capital by the full $2000, represented by the shares, even though the purchase price was $1980. If it were to do so, the $20 surplus ($2000 - $1980) created, by reason of VA. CODE ANN. § 13.1-67 (1978 Repl. Vol.) (the analog of MODEL ACT § 70) would be capital surplus. If the board were to reduce capital by only $1,000, the remaining $980 would be charged against earned surplus.

The latitude which § 13.1-63 gives the board of directors to determine the amount of the reduction of capital, and thus the amount by which creditors may be advantaged at the expense of junior shareholders, is not unique. Both VA. CODE ANN. § 13.1-18 (1978 Repl. Vol.) and MODEL ACT § 21 provide that the board of directors may transfer part of the surplus of a corporation to stated capital. Essentially, § 13.1-63 accomplishes the same thing. If capital is not reduced by the full amount of the stated capital represented by the cancelled shares, the difference is charged to surplus. The only difference is that under § 13.1-63 the same result would occur if there were no surplus, a deficit could be created or increased, whereas § 13.1-18 and MODEL ACT § 21 presume the existence of a surplus.

Since section 13.1-66 indicates cancellation takes effect only upon issuance of the certificate of reduction, Virginia avoids the anomalous result of the Model Act in which earned or capital surplus, if the source of the redemption or purchase, remains unrestricted.[152] If the shares were redeemed or purchased from earned or capital surplus, section 13.1-4 would restrict the source so long as the shares were held as treasury shares. Section 13.1-2(f) would include the the redeemed or purchased shares as treasury shares until cancellation.

IV. Conclusion

This exposition of some of the ambiguities and uncertainties in the Model Act and the Virginia statutes does not lend itself to general conclusions. It seems clear, however, that the advantage accorded a redemption of shares by these statutes provides corporate planners with a flexible device usable in determining an optional capital structure. This article attempts to demonstrate some possible uses and advantages of redemption provisions as well as their attendant uncertainties. The recent revisions to the Model Act[153] would eliminate the concept of redemption and would allow a flexibility in planning for corporate distribution to shareholders beyond that presently attainable even with the use of redemption provisions, and would eliminate the uncertainties surrounding these provisions.

152. *See* notes 96-105 *supra,* and accompanying text.
153. *Supra* note 3.