STOCK REPURCHASE AGREEMENTS: CLOSE CORPORATION USE OF DESIGNEE PROVISION PERMITS REPURCHASE DESPITE INSUFFICIENT EARNED SURPLUS

All states impose restrictions on the repurchase by a corporation of its own stock. Usually, if a corporation does not meet surplus and solvency tests it will not be permitted to repurchase its own stock.[1] In *In re Estate of Brown*,[2] the Appellate Court of Illinois held that a close corporation could exercise an option to repurchase its own stock through a designee, even though it did not have the earned surplus required by the Illinois Business Corporation Act.[3] In 1959, Brown sold 50% of his interest in two wholly owned Illinois corporations to Cole. A stock repurchase agreement authorized by the respective boards of directors of the two companies was executed simultaneously with the sale of Brown's stock. Section 7 of this agreement provided that upon the death of either Brown or Cole, "the Companies or their designees shall, for ninety (90) days from and after the date of his death, have the right and option to purchase all of his Stock from his estate."[4] The decedent stockholder's estate would sell all of the decedent's stock to the companies at a price which would be the greater of the book value[5] as of the date of death or an amount established in a certificate of agreed value executed periodically by the stockholders themselves.[6] After Brown's death, the two companies notified his executors of their desire to exercise the option and purchase Brown's shares at book value.[7] The executors, realizing that

1. 7 Z. CAVITCH, BUSINESS ORGANIZATIONS § 148.05[2] (1965) [hereinafter cited as CAVITCH].

The following hereinafter citation will also be used in this note: 2 F. O'NEAL, CLOSE CORPORATIONS (1958) [hereinafter cited as O'NEAL].

2. ___ Ill. App. 2d ___, 264 N.E.2d 287 (1970).

3. ILL. REV. STAT. ch. 32, § 157.6 (Supp. 1971).

4. ___ Ill. App. 2d at ___, 264 N.E.2d at 292-93.

5. Section 11(a) of the stock repurchase agreement provides that book value shall be "determined by the regularly employed auditors of the Companies on the basis of standard accounting principles applicable to the business of the Companies," and that "the book value of the Stock as determined by the auditors, shall be binding and conclusive on all persons." *Id.* at ___, 264 N.E.2d at 289.

6. The shareholders never certified the agreed value of the stock, and the book value thus became the only possible contract price. *Id.*

7. The companies offered to pay $22,586 after determining that the stock in the first company had a book value of $60,621, while the stock in the second company had a *negative*

Brown's stock had increased in value beyond the contract price, refused to accept the offer, and the companies petitioned the court for an order compelling the executors to comply with the stock repurchase agreement.

The trial court denied specific performance primarily because Section 6 of the Illinois Business Corporation Act prohibits a corporation from purchasing its own stock when, as in the present case, the corporation does not have sufficient earned surplus from which to make the purchase.[8] In addition, the trial court concluded that enforcement of the option would be "clearly inequitable and oppressive,"[9] since the disparity between the option price and the fair market value of the stock was substantial. The appellate court reversed, holding that Illinois grants specific performance when there has been an increase in value of the subject matter of a contract in the absence of fraud or concealment.[10] Yet, the appellate court specifically held that the companies could not legally purchase the stock under Section 6 of the Business Corporation Act,[11] for it was well-established in Illinois that a corporation could not repurchase stock when such a repurchase would impair its capital structure and jeopardize the interests of its creditors and other stockholders.[12] The court noted that although Section 6 does not explicitly limit the repurchase to corporate earnings, in *Precision Extrusions, Inc. v.*

---

book value of $15,449. The offer price was determined by taking 50% of the difference between the values of the two different stocks. *Id.*

8. A corporation shall have the power to purchase, take, receive, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares, provided that it shall not purchase, either directly or indirectly, its own shares when its net assets are less than the sum of its stated capital, its paid-in surplus, any surplus arising from unrealized appreciation in value of revaluation of its assets and any surplus arising from surrender to the corporation of any of its shares, or when by so doing its net assets would be reduced below such sum. . . . No purchase of its own shares shall be made at a time when the corporation is insolvent or when such purchase would render the corporation insolvent. ILL. REV. STAT. ch. 32, § 157.6 (Supp. 1971).

9. ___ Ill. App. 2d at ___, 264 N.E.2d at 290. The trial court also ruled that the stock in the second corporation could not have a book value less than zero, and that the proper option price was $30,310.50. *Id.* at ___, 264 N.E.2d at 291.

10. *See In re* Frayser's Estate, 401 Ill. 364, 82 N.E.2d 633 (1948). The mere fact the value of the property has increased or diminished since the contract was executed ordinarily will not warrant a refusal to carry out its terms, in the absence of circumstances indicating fraud or bad faith. *Id.* at 371-72, 82 N.E.2d at 637-38.

11. ___ Ill. App. 2d at ___, 264 N.E.2d at 293.

12. *See* Olmstead v. Vance & Jones Co., 196 Ill. 236, 242, 63 N.E. 634, 637 (1902); Commercial Nat'l Bank v. Burch, 141 Ill. 519, 528, 32 N.E. 420, 422 (1892); Fraser v. Ritchie, 8 Ill. App. 554, 557-58 (1881).

Stewart[13] the court had construed Section 6 as providing that corporations may only draw upon earned surplus for such stock repurchases. Since neither of the appellants had earned surplus at the time they sought to exercise their options,[14] they were not entitled to purchase Brown's stock. The court noted that the prohibition posed by Section 6 was raised for the first time as a defense in the trial court. It further indicated that if the limitations on repurchase under Section 6 had been mentioned by Brown's executors when the notice of the exercise of the option was given, the companies could have named a third party as their designee under section 7 of the repurchase agreement. The court implied that the surviving partner could become a designee if he financed the purchase himself[15] and asserted that Section 6 of the Business Corporation Act would not provide a defense for the executors upon a showing in the trial court that a third party designated by the companies was purchasing the decedent's stock. The court reversed and remanded with instructions to permit amendments or further pleadings upon the event that the companies should decide to appoint a designee.

Stock Repurchase Agreements

A stock repurchase agreement is a contract between a stockholder and a corporation whereby the corporation either binds itself to purchase or obtains an option to purchase part or all of the stock owned by a stockholder.[16] In return, the stockholder agrees to sell his stock only to the corporation.[17] The typical stock repurchase agreement obligates the corporation to purchase, or to exercise its option, upon the occurrence of a specified event, such as the severence

13. 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962).

14. Although the court never specifically described the inadequacy of the companies' earned surplus, it did indicate that both companies were operating at a deficit of approximately $90,000. ___ Ill. App. 2d at ___, 264 N.E.2d at 288.

15. ___ Ill. App. 2d at ___, 264 N.E.2d at 294.

16. "Repurchase" should be distinguished from "redemption" of shares, since "redemption" is a corporation's purchase "of its own shares exercised pursuant to pre-existing redemption provisions in the articles or certificate of incorporation which are part of the shareholder's contract with the corporation." CAVITCH § 147.05[2]. The financial restrictions imposed on stock redemptions are also less stringent than those imposed on stock repurchases. *Id.* § 147.05[1].

17. *See* O'NEAL § 7.27. However, an absolute restraint which is unlimited in time is invalid. O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 777-78 (1952). Reasonable restraints on transfers are permissible. H. BALLANTINE, CORPORATIONS § 336 (1946); 12 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5453 (1957).

of the stockholder's connection with the corporation, the disability of the stockholder, or the death of the stockholder.[18] Such agreements are employed principally by close corporations in an effort to preserve their "closeness" by limiting the class of potential stockholders[19] and by preventing the decedent's stock from being acquired by outsiders who may disrupt managerial harmony. A repurchase agreement usually constitutes a valid restraint on transfer after the stockholder's death[20] and provides liquidity for the estate of a deceased stockholder by assuring a market for close corporation stock which frequently has no active market and therefore no readily ascertainable market value.[21]

There are many possible methods of repurchasing the stock of deceased stockholders.[22] The corporation itself may purchase, in which case the agreement is called either an "entity purchase" plan, a "stock retirement" plan, or a "stock redemption" agreement.[23] If the corporation alone is to purchase the stock, as was requested by the companies in *Brown*, the corporation frequently will be able to finance such a repurchase only out of past or future earnings.[24] Under certain circumstances, however, the corporation may borrow funds for the repurchase from a third party and repay such a loan from subsequent earnings.[25] Reserve funding may also be implemented by investing a portion of each year's corporate earnings in liquid assets until a funded reserve sufficient to cover the purchase price has been accumulated. Yet, reserve funding is hazardous since a stockholder could die before a sufficient reserve is accumulated. The corporation may, as another method of repurchase, purchase life insurance policies on the lives of its stockholders and then use the proceeds of the

18. CAVITCH § 148.01.

19. *Id.* § 147.01.

20. For a list of the various types of restrictions on transfers, *see* O'NEAL § 7.05. *See also*, WYO. STATS. ANN. § 17-36.32(c) (1965) (authorizing corporations to impose restrictions on the sale or disposition of their stock).

21. *See* Note, *Close Corporation Stock Repurchase Agreements*, 11 W. RES. L. REV. 278, 279 (1960).

22. *See generally* Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business*, 46 IOWA L. REV. 516 (1961).

23. Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1, 2 (1969). *See* O'NEAL § 7.10.

24. *See generally* Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961). As a result, it is possible that the accumulated earnings tax [INT. REV. CODE OF 1954, §§ 531-37] will be applied to these funds. *See generally* 7 J. MERTENS, FEDERAL INCOME TAXATION § 39.01 -.58 (1967).

25. *Cf.* Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967).

policies, made payable to the corporation upon the death of a stockholder, to redeem the decedent's stock.

As an alternative to repurchases by the corporation, the purchasers could be the surviving stockholders themselves. Agreements whereby the surviving stockholders are to make the purchase, which are referred to as "cross-purchase" agreements,[26] can be financed by insurance plans or by the personal notes of the surviving stockholders. Finally, repurchase can be effected by a group of purchasers who exist outside of the corporation. For example, a "buy-out trust" can be established to hold the decedent's stock and can be funded either with corporate assets or insurance acquired on the life of the deceased stockholder.[27] As in *Brown*, purchase rights pursuant to a repurchase agreement may be assigned to and exercised by third parties or designees appointed by parties to the repurchase agreement.

Restrictions on Stock Repurchase Agreements

State statutes once absolutely prohibited corporations from purchasing their own stock, and in England this prohibition is still enforced.[28] Most states, however, have expressly rejected the English rule[29] and have adopted statutes permitting corporations to purchase their own stock.[30] There is probably no jurisdiction which would now hold that corporations are incapable of making such purchases,[31] although a few specific types of corporations, such as banking corporations, are prohibited from acquiring their own stock except in special circumstances.[32] Mandatory stock repurchase agreements will be valid in almost all jurisdictions;[33] yet, if the provisions of the

26. *See generally* O'NEAL § 7.27; Kahn, *supra* note 23, at 51-63.

27. *See generally* O'NEAL § 7.27; Polasky, *supra* note 22.

28. Trevor v. Whitworth, 12 App. Cas. 409 (H.L. 1887) (establishing the English rule). *See generally* 6A W. FLETCHER, *supra* note 17, at § 2846; Levy, *Purchase by an English Company of Its Own Shares*, 79 U. PA. L. REV. 45 (1930).

29. BALLANTINE, *supra* note 17, at § 256(a); 6A W. FLETCHER, *supra* note 17, at §§ 2847-48.

30. *See* 1 ABA MODEL BUS. CORP. ACT ANN. § 5, ¶ 2.02 (1960); CAVITCH § 147.03, n.3 (includes the citation for each state statute). *See generally* Kessler, *Share Repurchase Under Modern Corporation Laws*, 28 FORD. L. REV. 637 (1960).

31. CAVITCH § 147.03.

32. *See* Kassler v. Kyle, 28 Colo. 374, 65 P. 34 (1901); Quinn v. Ellenson, 236 Wis. 627, 296 N.W. 82 (1941). *See also* The National Bank Act, 12 U.S.C. § 83 (1964) (imposing restrictions on national banks); N.Y. BANKING L. § 103(6) (McKinney Supp. 1970); W. VA. CODE ANN. § 31-1-40 (1961).

33. O'NEAL § 7.10.

agreement are too severe on either party, the risk of invalidity is increased.[34] In *Topken, Loring & Schwartz, Inc. v. Schwartz*[35] the New York Court of Appeals ruled a stock repurchase agreement invalid as lacking mutuality of obligation. The court reasoned that since there was always a possibility that the corporation might not have funds available when the time came to make the purchase, its promise to purchase was therefore illusory and unenforceable. Yet, the *Schwartz* decision has been repudiated both by subsequent cases[36] in some jurisdictions and by legislative enactment in New York,[37] and it is certain that most courts would uphold stock repurchase agreements as binding promises, even though conditioned upon ability to pay at the time designated for purchase.[38]

Restrictions imposed upon a corporation's repurchase of its own stock are analogous to the restrictions imposed upon the payment of dividends. Both the repurchase of stock and the distribution of dividends are tantamount to a distribution of corporate assets to shareholders without consideration.[39] States have always recognized the dangers inherent in the purchase by a corporation of its own stock, and prior to any statutory provisions, a common law doctrine evolved which rendered repurchase payments made by a corporation invalid when the rights of creditors were prejudiced.[40] There was a recognition that such repurchase agreements also could impair the rights of other stockholders by decreasing the capital resources with which income could be earned and by diminishing the number of shares, thus giving each non-selling stockholder a larger interest in a decreased amount of total assets.[41] Although most states have attempted to improve this common law rule by drafting statutes which limit the power of a corporation to purchase its own stock, most of these statutes have been criticized as poorly drafted and inadequate.[42] Under present state

34. *See* Greene v. E.H. Robbins & Sons, Inc., 22 Del. Ch. 394, 2 A.2d 249 (Ch. 1938).

35. 249 N.Y. 206, 163 N.E. 735 (1928).

36. *See, e.g.*, Cutter Labs., Inc. v. Twining, 221 Cal. App. 2d 302, 313-14, 34 Cal. Rptr. 317, 324 (1st Dist. Ct. App. 1963).

37. N.Y. Bus. Corp. Law § 514(b) (1963).

38. O'NEAL § 7.10.

39. *See* Fultz v. Anzac Oil Corp., 240 F.2d 21, 22-24 (5th Cir. 1957); Robinson v. Wangeman, 75 F.2d 756, 757 (5th Cir. 1935).

40. *See, e.g.*, Barrett v. W.A. Webster Lumber Co., 275 Mass. 302, 175 N.E. 765 (1931).

41. *See generally* 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 492 (1959); R. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 279-81 (1949).

42. *See* BALLANTINE, *supra* note 17, at 610. *See generally* Kessler, *supra* note 30; Nussbaum, *Acquisition by a Corporation of Its Own Stock*, 35 COLUM. L. REV. 971 (1935).

statutes, financial limitations are determined by either surplus requirements, solvency requirements, preferential rights requirements,[43] or by a combination of these limitations.[44] Surplus is distinguishable from solvency in that surplus refers to an excess of assets over stated capital, whereas solvency refers to a corporation's ability to pay its debts and obligations as they become due.[45] The requirement that stock be repurchased only from surplus was recognized at common law.[46] However, most courts refused to limit repurchases to surplus in the absence of an express statute and simply required that the rights of creditors not be prejudiced.[47] Virtually all states now have some form of surplus requirement, whether specified as earned surplus,[48] capital surplus combined with earned surplus,[49] or simply as any surplus.[50] Regardless of the various surplus requirements, most states follow Section 5 of the Model Business Corporation Act and allow corporations to circumvent the surplus requirements in limited instances.[51]

After the "no prejudice" rule requiring that repurchases of stock not be conducted in a manner detrimental to the corporation's

---

43. *See* CAVITCH § 147.04[1].

44. *See, e.g.*, CAL. CORP. CODE §§ 1707-08 (West 1955) (repurchase confined to earned surplus *and* conditioned upon solvency).

45. CAVITCH § 147.04[1].

46. *Id.*

47. *See generally* Note, *Stock Repurchase Abuses and the No Prejudice Rule*, 59 YALE L.J. 1177 (1950).

48. *See, e.g.*, CAL. CORP. CODE §§ 802(e), 1704-08 (West 1955); D.C. CODE ENCYCL. ANN. § 29-904a (1968); ILL. REV. STAT. ch. 32, § 157.6 (Supp. 1971); 18 OKLA. STAT. ANN. tit. 18, §§ 1.19(8), 1.136 (1953), 1.137 (Supp. 1970).

49. *See, e.g.*, ALA. CODE tit. 10, § 21(57) (Supp. 1970); CONN. GEN. STAT. ANN. § 33-358 (1960); ORE. REV. STAT. § 57.035 (1969); PA. STAT. ANN. tit. 15, § 1701 (1967).

50. *See, e.g.*, COLO. REV. STAT. § 31-2-2 (1963); FLA. STAT. ANN. § 608.13(9)(b) (1956); N.Y. BUS. CORP. L. §§ 202(a)(14), 513 (1963); N.C. GEN. STAT. § 55-52 (1965); VA. CODE ANN. § 13.1-4 (1964).

51. Notwithstanding the foregoing limitations, a corporation may purchase or otherwise acquire its own shares for the purpose of: (a) Eliminating fractional shares. (b) Collecting or compromising claims of the corporation, or securing any indebtedness to the corporation previously incurred. (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. ILL. REV. STAT. ch. 32, § 157.6 (Supp. 1971).

This section is identical to Section 5 of ABA MODEL BUS. CORP. ACT ANN. (1960). The latest revision of the Model Act deletes the provision for acquiring shares to secure a previously incurred indebtedness. ABA MODEL BUS. CORP. ACT (1969). *See also* ALA. CODE tit. 10, § 21(57) (Supp. 1970); CONN. GEN. STAT. ANN. § 33-358 (1960); MO. ANN. STAT. § 351.390 (1966); UTAH CODE § 16-10-5 (1962).

creditors, a rule logically evolved that whenever a corporation became insolvent, it could not repurchase stock.[52] A repurchase made during solvency, however, would not be rendered invalid by subsequent insolvency.[53] Due to the uncertainty surrounding the standards for insolvency, many state courts adopted either the "equity insolvency" test of inability to meet debts as they mature[54] or a test comparing salable assets with existing debts.[55] A minority of state courts and most federal courts adopted the "bankruptcy insolvency" test of the Bankruptcy Act.[56] Statutes with financial limitations may also include preferential rights provisions requiring that after the repurchase of stock by a corporation, its net assets must not exceed the value of any preferential rights of stockholders occurring upon liquidation.[57] However, preferential rights limitations have not been widely adopted.[58]

The timing of surplus and solvency requirements is also crucial in determining whether a repurchase agreement satisfies an appropriate statute. Most courts follow the rule that stock repurchase agreements are valid when made, even if there is no guarantee that at the time of actual payment the corporation will be able to meet surplus or solvency tests.[59] Yet, when an obligation matures under a stock repurchase agreement, the agreement usually will be held to be unenforceable if the corporation cannot meet the solvency or surplus requirements of state law.[60] The question of when to determine the existence of surplus or solvency conditions is therefore central to the validity of a particular agreement. In states applying an insolvency

52. *See* Dodd, *Purchase and Redemption by a Corporation of its Own Shares: The Substantive Law*, 89 U. PA. L. REV. 697, 701 (1941).

53. *Id.* at 703.

54. *See* Calnan v. Guaranty Sec. Corp., 271 Mass. 533, 542-43, 171 N.E. 830, 834 (1930). This standard is expressly adopted in § 2(n) of the 1969 ABA MODEL BUSINESS CORPORATION ACT.

55. UNIFORM FRAUDULENT CONVEYANCE ACT § 2(1), 9b UNIFORM LAWS ANN. (1966): "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."

56. 11 U.S.C. 1(19) (1964). (A person is insolvent "whenever the aggregate of his property . . . shall not at a fair valuation be sufficient in amount to pay his debts . . . .")

57. *See, e.g.*, N.C. GEN. STAT. § 55-52 (1965); S.C. CODE §§ 12-12.2(19), 12-15.17 (Supp. 1970); WIS. STAT. ANN. § 180.385 (1957).

58. CAVITCH § 147.04[1].

59. *Id.* § 148.01.

60. *See, e.g., In re* Tichenor-Grand Co., 203 F. 720 (S.D.N.Y. 1913); Goodman v. Global Indus., 80 Cal. App. 2d 583, 182 P.2d 300 (1st Dist. Ct. App. 1947).

test, the date when installments or payments are due under the repurchase agreement is the appropriate time to apply the test, rather than the contract date. Furthermore, once a corporation becomes insolvent, any payment under a repurchase obligation gives standing to subsequent creditors to have the transaction declared invalid if they were without knowledge of the purchase[61] or to have the unpaid balance on the repurchase obligation subordinated to their claims.[62] However, the status of subsequent creditors is still uncertain, for some cases have allowed subsequent creditors *with knowledge* to contest a repurchase agreement,[63] while a few decisions have held that *no* subsequent creditor has standing.[64] Under surplus requirements, corporations are not required to have a surplus at the outset equal to the total repurchase obligation; they are only required to have adequate surplus to cover the obligation when it is due.[65] Under an installment agreement there must be adequate surplus to cover each installment when due.[66] A repurchase agreement that is valid at the time it is entered into becomes invalid if there is no surplus at the time of payment[67] and is unenforceable against the corporation.[68] When a corporation has a surplus at the time a repurchase agreement is made, however, the rights of the creditors of the corporation are not defeated if the corporation does not have a surplus at the time payments under the agreement are actually made.[69] Stockholders are often granted specific performance against the corporation when the corporation has refused to purchase and cannot prove insufficiency of surplus or insolvency at the time for performance.[70] On the other hand, some courts have allowed specific performance where stockholders had purchased their shares in reliance upon a repurchase agreement, even

61. *See* Jarroll Coal Co. v. Lewis, 210 F.2d 578, 580-81 (4th Cir. 1954); Kleinberg v. Schwartz, 87 N.J. Super. 216, 223-24, 208 A.2d 803, 808 (App. Div.), *aff'd per curiam*, 42 N.J. 2, 214 A.2d 313 (1965).

62. DODD, *supra* note 52, at 701.

63. *See, e.g.*, Loveland & Co. v. Doernbecher Mfg. Co., 149 Ore. 58, 39 P.2d 668 (1934); *see generally* DODD, *supra* note 52, at 701-02.

64. *See, e.g.*, Kaminsky v. Phinizy, 54 F.2d 16, 17 (5th Cir. 1931).

65. *See* Gifford v. Rich, 58 Ill. App. 2d 405, 208 N.E.2d 47 (1965).

66. *See* Mountain State Steel Foundaries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960).

67. *See In re* Mathews Constr. Co., 120 F. Supp. 818, 821 (S.D. Cal. 1954).

68. H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS 174-75 (1938).

69. Kleinberg v. Schwartz, 87 N.J. Super. 216, 224, 208 A.2d 803, 808 (App. Div. 1965).

70. *E.g.*, Murphy v. George Murphy, Inc., 7 Misc. 2d 647, 166 N.Y.S.2d 290 (Sup. Ct. 1957).

though any repurchase by the corporation at the time for performance would have been impermissible.[71]

Avoiding Restrictions on Stock Repurchase Agreements

As *Brown* indicates, statutory solvency and surplus restrictions can be avoided, but not directly violated, for, at least in Illinois, directors who violate the statutory requirements for repurchase may be personally liable, even though state statutes do not specifically prescribe such responsibility.[72] The earned surplus restriction imposed by Illinois would not be difficult to avoid; any company with insufficient earned surplus wishing to repurchase its own stock could do so by purchasing within the earned surplus limitation and then retiring the purchased shares.[73] Stated capital would thus be reduced and earned surplus would be freed for subsequent acquisitions. In addition, section 6 of the Illinois Business Corporation Act allows corporations to reduce their capital or paid-in surplus in order to purchase shares for the purposes of eliminating fractional shares, compromising claims of the corporation, paying dissenting shareholders, and redeeming redeemable shares.[74] When repurchase is to be carried out by installments, a corporation which does not have adequate surplus at the time of the agreement can validate the repurchase by including a provision in the agreement under which each installment would be construed as a separate repurchase transaction.[75] If there is a possibility that a corporation may not be able to pay the repurchase price upon the date of performance, a provision could be included in the repurchase agreement whereby the shares to be purchased would be placed in escrow until the corporation is able to finance the purchase in compliance with the appropriate state statute.[76] Provisions could be included in the repurchase agreement providing for a reappraisal of the corporation's assets to determine a true market value of those assets; and if the reappraisal still results in an insufficient surplus, the stockholders

71. *See* Williams v. Maryland Glass Corp., 134 Md. 320, 106 A. 755 (1919); Grace Sec. Corp. v. Roberts, 158 Va. 792, 164 S.E. 700 (1932).

72. Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 42, 183 N.E.2d 547, 553 (1962).

73. For a repurchase agreement form containing a clause in anticipation of insufficient surplus, *see* 6 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, Form No. 15.29 (1970).

74. ILL. ANN. STAT. ch. 32, § 157.6 (Supp. 1971); see note 45 *supra*.

75. See note 60 *supra* and accompanying text.

76. *See* O'NEAL § 7.10 n.48.20 (Supp. 1970).

could contribute cash and other property to the corporation to increase the surplus to the statutory amount.[77] An additional provision could be included providing that if after reappraisal and contribution by stockholders the surplus is still insufficient, all remaining stockholders would be obligated personally to finance the purchase.[78] A surplus also could be obtained by a reduction of stated capital prior to the time of the repurchase.[79] A capital reduction, however, must conform to the appropriate statutory standards limiting the amount and manner of the reduction[80] and restricting the permissible uses of a capital reduction surplus.[81] Yet, capital reduction surplus cannot be included as part of earned surplus under some statutes[82] and thus will not be allowed to satisfy earned surplus requirements in these jurisdictions.

Courts and legislatures have both recognized the distinction between public issue and close corporations and the need for less governmental control over the latter type of corporation,[83] yet statutes prescribing surplus and solvency limitations are still strictly construed even for the close corporation. In *Brown,* the court specifically held that the companies had not satisfied the statutory requirements for repurchasing their own stock and that the repurchase agreement was unenforceable if the companies themselves were to purchase.[84] Under the circumstances of the repurchase agreement, which obligated the companies "to take all other action, required or advisable"[85] to effectuate the agreement and allowed the companies to designate other parties to exercise the option, the court concluded that failure to comply with the solvency and surplus requirements did not provide Brown's executors with an absolute defense to specific enforcement of

77. CAVITCH § 148.05[2] n.10.

78. *Id.*

79. *See* Cunningham, *Stock "Buy-Out" Plans: Selection and Drafting,* 18 MD. L. REV. 277, 287 (1958).

80. *See, e.g.,* CAL. CORP. CODE § 1904 (West Supp. 1970) (both director and shareholder vote); DEL. CODE ANN. tit. 8, § 244(b) (Supp. 1968).

81. *See, e.g.,* CAL. CORP. CODE § 1907 (West 1955); MINN. STAT. § 301.39 (1969) (limited by any existing preferences).

82. *See, e.g.,* TEX. BUS. CORP. ACT arts. 2.03C, 2.03D (1956).

83. *See, e.g.,* Kauffman v. Meyberg, 59 Cal. App. 2d 730, 140 P.2d 210 (2d Dist. Ct. App. 1943); Chambers v. Beaver-Advance Corp., 392 Pa. 481, 492, 140 A.2d 808, 814 (1958).

84. "Inasmuch as neither of the Companies had earned surplus when they attempted to exercise the option, we must conclude on the basis of the foregoing that the Companies were not legally permitted to purchase the decedent's shares." ___ Ill. App. 2d at ___, 264 N.E.2d at 292.

85. *Id.* at ___, 264 N.E.2d at 293.

the contract.[86] Due to the provision for designees, the statute would not be violated *if* designees were appointed, and specific performance would be granted in favor of these designees. Thus, *Brown* is neither a repudiation of the surplus and solvency requirements nor an indication of leniency in enforcing the contractual obligations of the close corporation. By upholding the designee provision, the court merely recognized an additional method of circumventing surplus and solvency requirements. If surviving stockholders are allowed to become designees, the objectives of excluding outsiders and maintaining the close corporation's "closeness" will be preserved just as effectively as if the corporation itself were allowed to repurchase the shares of a decedent stockholder. The two contracting stockholders in *Brown* obviously intended to have the survivor maintain complete control of all shares, and by upholding the designee provision, the court recognized that the stockholders' intention of giving the controlling interest to the survivor was of primary importance and should not be defeated by the statutory earned surplus requirement. The consequences of allowing either the companies or the surviving stockholder to purchase the decedent's shares would be identical, for in either case the survivor would be able to exercise control over all of the companies' shares. Therefore, designee provisions should assume an important role in the drafting of stock repurchase agreements. While the parties to such agreements should always contemplate the possibility of unenforceability due to inadequate surplus or unanticipated insolvency, the presence of a designee provision, coupled with an obligation to use all possible means to effectuate the intentions of the parties, will allow the satisfactory disposition of a decedent's shares despite inability to comply with statutory limitations.

86. *Id.*