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THE REGULATION OF TREASURY STOCK TRANSACTIONS

by
Leonard George Eckel

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Doctoral Committee:

Professor C.J. Pilcher, Chairman
Professor Robert L. Dixon
Professor Sidney Jones
Assistant Professor Stanley Siegel
Professor J.P. Wernette

ABSTRACT

THE REGULATION OF TREASURY STOCK TRANSACTIONS

by

Leonard George Eckel

Chairman: C.J. Pilcher

The objective of this study is the formulation of recommendations concerning the public regulation of the treasury stock transactions of United States business corporations. This study deals with the question of the acceptability of the stock reacquisition transaction as a technique of corporate financial management. In order to achieve a meaningful analysis of the transaction, the legal, regulatory, income-tax and financial factors involved are considered as an interrelated group.

The transaction is considered in terms of the implications for a corporation's shareholders of both the transaction per se and the objectives of the transaction. The position is taken that if either the transaction itself or its objectives are found to have objectionable implications, then there is reason to question the desirability of allowing the transaction to continue. If an objective is acceptable, but the transaction has objectionable implications, then the objective should be achieved by other means. If the objective is unacceptable, then the transaction should not be carried out. Accordingly, an analysis is made of the implications of reacquisition of the objectives of reacqui-

sition, and of the alternative means of achieving those objectives which are considered legitimate and desirable.

Chapter II sets out the scope and limits of the study and includes a brief review of the literature and a summary of available statistical evidence concerning the practical significance of treasury stock transactions. Chapter III deals with the nature of the transaction, the financial variables which determine the effects of the transaction on the corporation and its shareholders, and the problem of measuring these effects. Chapters IV and V deal with the legal, regulatory and federal income-tax status of the transaction.

Chapter VI deals with the potential implications of reacquisition and includes an analysis of the several methods of stock reacquisition. In Chapter VII, the legal, regulatory, income-tax and financial factors which contribute to the individual objectives of reacquisition, the implications of each objective, and the availability of alternative means of achieving each objective are considered.

The reacquisition transaction -- regardless of its objective -- may have undesirable implications for a corporation's shareholders unless all reacquisitions are pro rata. Inequity among shareholders may result from non-proportional reacquisition, even in the absence of deliberate favoritism on the part of the corporation or the controlling shareholders. The reacquisition transaction differs significantly from the ordinary share transaction (in which the corporation is not

involved), in that a shareholder may be harmed by a reacquisition of shares by his corporation, even though he is not party to, or even aware of, the transaction. This fact may warrant an approach to the protection of the shareholder which is different from that taken toward the ordinary share transaction.

While reacquisition for certain specific purposes is necessary to the operation of the corporation, a number of the common objectives of reacquisition are objectionable in that they are not consistent with the legitimate objectives of corporate financial management and do not conform with the generally held view of the fiduciary responsibility of the corporation to its shareholders. The remaining acceptable objectives can be attained by alternative means, thereby precluding the potential inequity involved with reacquisition.

In Chapter VIII, three alternate recommendations are proposed:

1) the prohibition, with minor exceptions, of reacquisition;

2) the requirement that all reacquisitions be pro rata;

3) the requirement that all reacquisitions be made by public tender-offer.

The recommendations are ranked in the order of diminishing effectiveness in protecting the shareholders' interest; the choice made must be based on the degree to which the shareholder is to be protected and the degree to which the reacquisition transaction, as it now exists, is to be curtailed or altered.

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CHAPTER I

Introduction--the topic and objective of this study.

This study deals with treasury stock transactions--a corporation's buying and re-selling of its own outstanding shares. Recently, a large and increasing number of corporations have been reacquiring their own shares.[1] The practice has aroused the interest of the business community, of academicians and of regulatory agencies. Some of the assertions to be found in the current periodical literature and financial press statements suggest a failure to understand the total effects of treasury stock transactions. Furthermore, the role that such transactions should play in corporate operations is subject to dispute. The positions taken by writers range all the way from "Speculation in its own shares is not either a normal or proper part of a corporation's business..."[2] to the other extreme that "...equity should be repurchased when it is an attractive investment, and sold when the dollars obtained are more valuable."[3] In view of the number of companies actively acquiring their own shares, it must be assumed that a substantial number of practicing corporate managers consider such transactions to be legitimate and proper. Statements made by corporate managers in the financial press and in corporate annual reports indicate a new and growing awareness of the potential of such transactions as a part of deliberate

financial policy. However, these same statements often indicate misconceptions as to the nature and consequences of the transactions, as do certain statements made by investment bankers and advisors. While the literature, historically as well as currently, has dealt with particular aspects of the issue, no comprehensive analysis of the many and interrelated legal, regulatory, financial and economic factors relating to treasury stock transactions has yet been made. (A brief review of the literature, including four recently completed dissertations, will be found in Chapter II.)

The present study differs from previous studies in that it is concerned with the desirability and necessity of stock reacquisition transactions. It will deal with the question of the acceptability of the reacquisition transaction as a technique of corporate financial management. Previous studies have assumed the acceptability of the reacquisition transaction, and have concerned themselves largely with measuring the extent of the practice or with describing the techniques employed.

To achieve a meaningful analysis of the treasury stock transaction, legal, regulatory, financial and economic factors must be considered as an interrelated group. The legal and regulatory background of the transactions, their objectives and methods, and the implications arising therefrom, will be examined. An analysis will be made of the economic variables involved, and of the effect of the transaction on the corpora-

tion and on its shareholders. The analysis will not only investigate the nature and existence of the effects, but it will also point out the difficulties of measurement and evaluation of the effects. In addition to being valuable in and of itself, such an analysis is necessary to achieve the primary objective of this study--the making of recommendations concerning public regulation of treasury stock transactions. The making of these recommendations necessitates reviewing present regulatory practices and arriving at a decision as to the nature and scope of regulation considered desirable. A survey of current corporate statutes and securities legislation indicates an almost total lack of regulation of treasury stock transactions, and such regulation as does exist is generally considered to be of limited effectiveness.[4]

I - The approach to be used.

In this study, the treasury stock transaction will be analyzed in terms of:

(a) the implications of the objectives of the transaction, and

(b) the implications of the transaction per se.

Conceptually, the objective of a particular transaction may be acceptable, while the method of carrying it out may have ramifications that are unacceptable. Conversely, the objective of the transaction might be deemed unacceptable, while the method of effecting it is acceptable. The position to be taken

in this study can now be stated. If it is found that:

(a) the various objectives of treasury stock transactions are unacceptable, or that

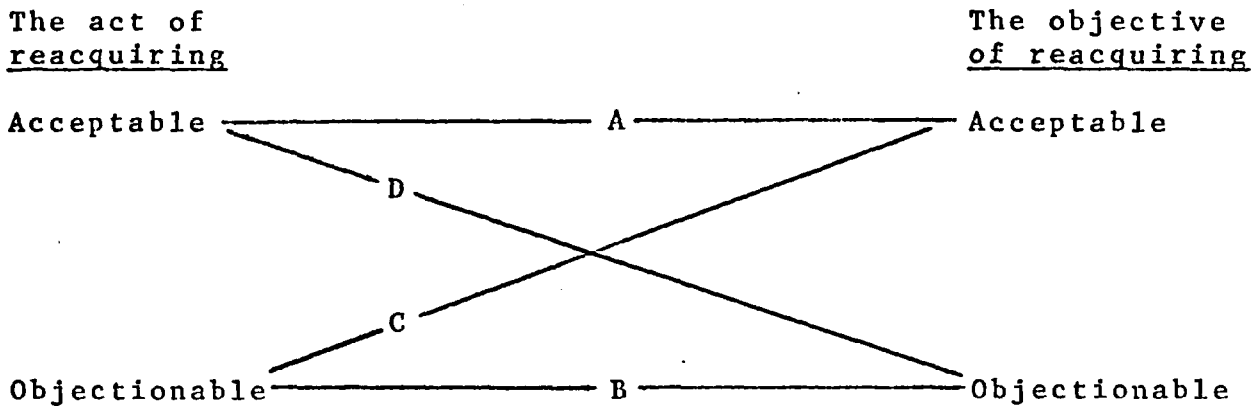
(b) treasury stock transactions per se have aspects, ramifications or implications that are unacceptable,

then there is reason to question the desirability of allowing such transactions to occur.

If a particular objective of treasury stock transactions is found to be unacceptable, then this finding would justify the discontinuance of transactions aimed at achieving that objective. If the objective is acceptable, then the ramifications of the transaction itself, including the implications of the method used to carry it out, must be examined; any undesirable implications of the transaction per se would suggest that the objective should be achieved by some other means. Conceptually, it is difficult to defend the toleration of objectionable aspects of treasury stock transactions, if the transactions themselves are unnecessary, (in that alternative means are available, or could be made available), or if they are aimed at achieving unacceptable objectives.

The approach outlined in the paragraph above can be made clearer by means of a diagram. The practice of a corporation's reacquiring its own shares will be judged on two bases: (i) the objective of the reacquisition and (ii) the act of reacquisition itself. Either of these may be objection-

able or acceptable. This yields the four possibilities shown in the diagram:



Combination A would be totally acceptable and combination B totally objectionable. Combination C, where the objective is acceptable, would indicate that it should be accomplished by some other method. Combination D would suggest that the objective does not justify the corporation's reacquiring its shares.

A treasury stock transaction will be classified as "objectionable" if its effects or its objective are shown to be inconsistent with the following three criteria:

(a) What financial writers consider to be a proper and legitimate objective of a business corporation.

(b) What an informed and reasonable person would consider to be an appropriate relationship of the corporate entity to the shareholder, and

(c) What such an informed and reasonable individual would consider to be a proper and equitable relationship between shareholders as individuals and as groups.

Admittedly, the above criteria contain a degree of vagueness, but the author believes a consensus of opinion sufficiently clear to make the necessary classification can be gleaned from the writings of academicians in the fields of law and finance, from the deliberations of the Courts, and from existing statute and regulation.

II - Scope and method of study.

This study is a conceptual and theoretical investigation of treasury stock transactions, based on an analysis of pertinent legal and institutional factors, and utilizing established theory in the field of corporation finance. Significant use will be made of published material in the field of corporation law and securities legislation. Legal, regulatory and tax factors have a significant impact on the use of stock reacquisition as a corporate technique. Furthermore, a knowledge of the present state of regulation is necessary not only of itself, but also as a guide for the making of recommendations concerning future regulation.

The four recently completed doctoral dissertations discussed in Chapter II will be used as a source of statistical data concerning the relative significance and scope of current

actual transactions, the objectives of the transactions, and the methods used by corporations to reacquire their shares.

In Chapter II, the topic of the study is defined, and the nature of treasury the stock transaction is explored as an aid in presenting the nature, scope and limits of this study.

In Chapter III, the relevant variables which determine the impact of the transaction on a corporation are identified and considered. The motivation for the transaction stems, directly or indirectly, from the effects which it is hoped the transaction will have on the corporation. The economic effect of the transaction on the corporation, and on the interest of the shareholder(s), are identified and the various methods of measuring the effects are examined. This analysis is necessary as a basis for the later analysis of the transaction by reference to their objectives and method.

Chapter IV presents the legal and regulatory status, and Chapter V, the federal income tax implications, of treasury stock and treasury stock transactions.

Chapters VI and VII contain an analysis of the implications of corporate stock reacquisition.[5] The actual implications of a given reacquisition are a function of many factors, all or most of which can be usefully related to

either the objective or the method of the reacquisition. In Chapter VI, the conceptual implications of a stock reacquisition per se are examined, necessarily including consideration of the methods by which the shares are reacquired. In Chapter VII, repurchase transactions are categorized by reference to the objective of reacquisition, and the implications of the various objectives considered one by one. The essential nature of the objectives, the legal, regulatory, and tax factors contributing thereto, and the theoretical and practical alternatives to stock reacquisition as a means of attaining these objectives, are examined. That chapter includes consideration of:

(a) the implications, actual and potential, of stock reacquisition per se;

(b) the implications, actual and potential, of the objectives of treasury stock transactions;

(c) the acceptability of certain objectives of treasury stock transactions, and the alternative means of accomplishing these objectives;

(d) those particular legal and regulatory factors which might contribute to the use of certain methods of stock reacquisition, or which form the motivation to stock reacquisition, or which render the alternative means either practically unavailable, or inferior to the treasury stock transaction.

In Chapter VIII, recommendations are made as to whether treasury stock transactions, as now conducted, should be left unchanged, facilitated and encouraged, restricted or eliminated entirely.[6]

Footnotes

1. Information concerning the practical significance of the transaction is presented below in Chapter II.

2. Ed Tyng, "Own stock purchases on rise", The Journal of Commerce (April 19, 1964), p.17.

3. C.A. Rundell, Jr., letter, Harvard Business Review, XLIII (November-December 1965), p. 39.

4. For a discussion of the nature of current regulation, see Chapter IV.

5. Since the re-issue of treasury shares is financially identical to the issue of new shares, (see Chapter III), the emphasis will be on the reacquisition of shares. Reacquisition for specific purposes may serve as the objective of stock reacquisition, and will be treated as such.

6. The recommendations could deal with changes in the area of direct regulation of transactions via the securities law and corporation statutes. Potential regulation ranges from absolute prohibition on the one hand to measures designed to facilitate the transactions on the other, including any combination of partial prohibition and regulation falling between these extremes. Probibition of the transactions could be accomplished by withholding from a corporation the right to reacquire its own shares. Partial prohibition could be implemented by limiting the extent of such transactions or by limiting the circumstances under which they can be carried out. Regulation could deal with the method of transactions, with requirement of disclosure, or with pertinent aspects of the shareholder-corporate relationship. Finally, the transactions could be encouraged by reducing the regulation to which such transactions are currently subjected.

Recommendations resulting from this study will be made

in only the broadest non-technical terms. While statute and common law and regulations will be examined, this aspect of the study is only for the purpose of revealing the nature of the treasury stock transactions, the implications of the transaction, or the present state of regulation. It will be considered adequate, for instance, to recommend that "the corporation should be allowed...," without suggesting either a model statute or specific amendments to specific statutory provisions.

CHAPTER II

The treasury stock transaction -- background and significance.

I - A brief survey of the literature.

Traditionally, the literature has dealt with only specific aspects of the treasury-stock transaction--the particular aspect treated being determined by the background of the researcher and author. Until recently, lawyers and accountants were the source of most discussion concerning treasury stock, but the recent wave of stock reacquisitions has caused an increase of interest on the part of students of corporation finance.

Traditional textbooks of corporation finance customarily include brief discussions of the reasons for repurchases of stock by corporations.[1] The reasons are usually given in general terms without rigorous analysis of the possible effects.[2] Normally, accountants concern themselves with the nature of the transaction only to an extent necessary to explain the appropriate accounting,[3] necessarily involving some attention to the provisions of corporate statutes.[4] Legal writers usually treat specific aspects of the transaction, and the implications of reacquisition under specific circumstances, such as the applicability of the pre-emptive right,[5] the possible effect on corporate control,[6] or the income tax aspects of the transactions.[7] In general, legal

writers restrict their analyses to a consideration of case decisions and statute law, with little attention being paid to the underlying economic factors. With the exception of the study of Holt and Morris,[8] discussed below, little research has been done on the nature of the treasury stock transaction per se. Holt and Morris did make an empirical study of repurchases by industrial corporations covering the three-year period from 1931 to 1933, with the objective of determining the motives for reacquisition. This appears to have been the first empirical study of stock reacquisition.[9]

While the recent increase in reacquisitions has resulted in an increase in the literature dealing with the subject, the emphasis is still on specific aspects of the transaction. The recent development of the theory of corporate financial management and of the cost of capital has enabled students of corporate finance to attempt a more rigorous analysis of the effects of the transaction on the corporation.[10] Legal writers have been concerned with the application of Rule 10b-5 to reacquisition transactions[11] and the problem of disclosure in connection with stock reacquisition.[12]

Two legal writers have taken a broader view of the transaction; Zilber[13] and Kessler.[14] The former deals with financial as well as legal considerations, and the latter systematically questions the desirability of stock reacquisition as it now occurs. Nevertheless, legal literature has, and does, basically assume the existence and

occurence of the reacquisition transaction as a normal procedure.[15]

Four doctoral dissertations dealing with certain aspects of the reacquisition transaction have recently been completed.[16] These dissertations are essentially empirical studies of recent reacquisition activities, using published data concerning actual transactions, and interviews with corporate executives. The four studies approach the reacquisition transaction as a part of deliberate corporate financial management, but do not question the desirability of, or need for, reacquisitions. Published abstracts of the dissertations are included as Appendix I. Because the abstracts may not be totally representative of the studies themselves, and to emphasize the points of difference between these studies and the present study, a brief comment on each follows.

Guthart's work is organized around three main areas:

(1) The question of the equitability of the repurchasing corporation's action to the stockholder who sells. He concluded that a major "gray" area exists in the body of law regulating share repurchase activities, and that possibilities for substantial abuse of stockholders' rights exist when corporations repurchase their own shares.

(2) An analysis of all repurchasing transactions of NYSE firms during the years 1954 to 1963, with certain as-

pects brought up to the end of 1965. The author's purpose here was to present some conclusions and data regarding the extent of repurchasing activity. The dissertation contains a number of tables that summarize the data on the number of corporations that repurchased shares (during the study period) and the number of shares repurchased, and relates these to total market activity in shares of these companies.

(3) A discussion of how the financial decision to repurchase common shares should be made. Here the author's conclusions are based on interviews with officials of repurchasing companies. Data is presented concerning the reasons why shares were repurchased, the methods used by the repurchasing corporations to evaluate repurchase, and the practices of corporations designed to minimize liability under the anti-manipulative section of the Securities Act.

The material presented is essentially descriptive in nature, but is useful insofar as it presents the position and thought patterns of the practicing corporate executive.

Rapp, in his study, examines the role of reacquired stock in financial management, and the factors that have contributed to the increase in the number of stock reacquisitions. He concludes that the contributing factors were a favorable federal income tax environment, an increase in

the number of corporations that adopted stock option plans, the level of stock market prices, and an increase in cash flows. His principal conclusion is that treasury common stock financing has come to play a prominent role in financial management. The final sentence of Rapp's summary is of particular interest for the purposes of this study:

> "Financial management is concerned with capital budgeting, maximizing the present value of the corporation, treating shareholders equitably, efficient allocation of resources, and liquidity and profitability. Treasury common stock financing is playing an important role in all these areas <u>because it is providing financial managers with a flexible method of financing</u> that they can use <u>in the best interests of the corporation and the shareholders</u>." (Emphasis mine.)

This conclusion implies that additional flexibility automatically serves the best interests of the corporation and its shareholders. He does not otherwise direct himself to the problem of determining if the "flexibility" may have some attendant cost.[17]

The purpose of Stevenson's study was to determine the reasons for the growth of common stock reacquisitions.[18] To do this, he analyzed the characteristics of all NYSE listed corporations which reduced their outstanding common stock by 1% or more in any year of the 1956-1963 period.[19] He also developed a model based on book-values to determine the rate of return on stock reacquisitions. One chapter of

his dissertation was devoted to legal and another to ethical considerations. In the legal chapter, he reiterated the legal right of a corporation to reacquire its own shares and pointed out that certain anti-fraud provisions of the federal securities laws are relevant. In the second chapter, entitled "The Ethics of Corporate Stock Reacquisition", he concludes that "the two main considerations are to see that full disclosure is made of the transaction, and to see that no conflict of interest situations result because of the decision to reacquire stock."[20] The conflict-of-interest situation to which he refers involves intended fraud by management, which he concludes could be avoided by adequate disclosure. He suggests that ethical considerations need more attention, especially regarding disclosure of open-market purchase in the financial press.[21]

Young, in his study, concerns himself only with the cash-tender-offer method of stock reacquisition and its effect on the three major interest groups--management, the securities market and the investor.[22] This is a behavioral study, utilizing multiple-correlation techniques in an attempt to identify the variables relevant to management's decision to make a tender-offer and the way to do so, the effect of the tender-offer on the market, and on the investor.[23] The author arrives at conclusions concerning these questions, based on a study of empirical data[24] supplemented by interviews with executives involved in the reacquisition

transactions.[25] His material is useful, not only for the present study, but also as a basis for further research on the question.

II - The significance of stock reacquisition in practice.

The reacquisition transaction is currently a significant phenomena when measured in terms of the number of corporations reacquiring, the number of shares involved or the dollar value of the transactions. The conclusions drawn by Guthart, Stevenson, and Rapp will be presented here to indicate this significance; the reader is referred to the original studies for the actual statistical data and for a detailed description of the research methodology employed.

In respect to the number of corporations involved, Rapp concluded that 44.5% of the corporations listed on the NYSE repurchased some of their common stock during the thirteen-year period of 1951 to 1963 inclusive,[26] and Guthart concluded that 42% of the companies listed on the NYSE reacquired some of their shares during the period 1954 to 1963.[27] These studies also indicate the increased significance of the transaction in the recent past. Rapp states that approximately one out of every four listed companies repurchased in 1962 and 1963, and that since 1951, there has been a steady fivefold increase in the number of corporations listed that have engaged in repurchase activity.[28]

The number of shares reacquired has become increasingly significant, as indicated by Table 1. The number of shares repurchased by NYSE corporations has risen steadily over the period with each year showing a gain over the last. The number of shares reacquired by all NYSE firms in 1965 was approximately 38.7 million as compared to 5.9 million in 1954. Repurchase as a percentage of the total number of shares traded on the NYSE has risen from 1.02% in 1954 to 2.15% in 1965. As a further indication of the significance of reacquisition to the corporations involved, Guthart reports that in 1963, 130 companies listed on the NYSE repurchased enough shares to account for 5% or more of the total trading in their securities.[29] Stevenson's study indicated that in the six years 1958 to 1963 inclusive, 217 corporations reduced their outstanding stock through reacquisition by one percent or more from one year to the next.[30]

In terms of the number of dollars spent in repurchasing the amount increased approximately 7 times--from $273.9 million to 1954 to approximately $2,000.0 million in 1965. Examination of Table 1 reveals that the amount spent in repurchase of shares has generally increased relative to the amount of funds raised by the issue of new shares. In 1963, and in 1965, the amount of funds used in repurchase was greater than that raised by new equity issues,[31] which differs significantly from 1954 when repurchase amounted to

TABLE 1.

Relative amounts of common stock repurchased

1954 to 1965 inclusive

	Total shares traded on the NYSE (a)	Shares repurchased (b)	Repurchase Proportion	Total dollars in repurchase (c)	Total dollars of equity issue (d)
	(000,000's)	(000,000's)	%	(000,000's)	(000,000's)
1954	703.1	5.9	1.02	$ 273.9	$ 1,212
1955	820.5	7.0	1.08	387.8	2,184
1956	699.2	8.0	1.45	414.3	2,301
1957	714.5	8.4	1.49	382.3	2,516
1958	921.5	9.8	1.31	465.7	1,334
1959	1,039.0	11.9	1.45	647.5	2,027
1960	958.3	12.8	1.67	598.4	1,664
1961	1,292.3	14.9	1.46	793.6	3,273
1962	1,186.5	23.3	2.42	1,056.7	1,318
1963	1,350.9	26.6	2.32	1,302.9	1,022
1964	1,482.5	37.4	2.49	1,900.0	2,679
1965	1,809.4	38.7	2.15	2,000.0	1,547

(a) New York Stock Exchange Fact Book, 1967.

(b) Guthart cited above. pp. 101,136.

(c) Ibid., the data for 1964 and 1965 appear to be "rough estimates", p. 136.

(d) Federal Reserve Bulletin, July 1966, Board of Governors of the Federal Reserve System, Washington, D.C.

approximately 20% of the capital raised by new equity issue.

Stevenson summarizes his findings as follows:

> All these calculations...prove that acquisition by a company of its own shares has become much more pronounced in the last three or four years. Included in the large increase of companies repurchasing stock are many companies that never repurchased share previously. Both the total and average market value of all repurchases have increased greatly.[32]

Young presented further evidence in this direction, by looking at the cash tender offer, one means of reacquisition. During the period December 1944 to October 1965, he finds that tender-offer reacquisitions occurred at a rate of 1.611 tender offers per month during the most recent 36 months (October 1962 to October 1965) as compared to a rate of .439 tender offers per month for the entire period.[33]

Guthart found in a subsequent study that stock repurchase activity during the first six months of 1966 continued at the same rate as the latter half of 1965.[34] The current literature indicates that reacquisition is of continuing significance,[35] and there is no evidence that the pace of reacquisition is declining.[36]

It would appear safe to conclude that the stock reacquisition transaction is significant enough to warrant an examination of the nature of the transaction--the purpose of this study.

III - Treasury stock.

Treasury stock transactions are peculiar to the corporate form of business organization and are a product of the legal distinction between a corporation and its owners, the shareholders. It is this distinction that makes possible an arms length transaction between the shareholder as shareholder, and the corporation as corporation, a separate entity. The corporation, created by legal process, is subject to exacting legal regulation, supervision and limitation during its existence. It is with the legally conferred powers and limitations and with the legally defined relationships between the corporation and its environment, that this study will be concerned. The corporation is created by law for the purpose of facilitating the attainment of a specific objective of its founders. This study is concerned with the business corporation, which is organized primarily for the profit of its owners.[37] The business corporation has been defined by Votaw in a manner particularly pertinent to this study:

> "(the)...private, profit, business organization formed in compliance with a state incorporation act and operating under a charter or articles of incorporation drafted and filed under the terms of such act."[38]

As a legal entity, the corporation is capable of engaging in such activities as are consistent with the

purpose for which it was created. In the business corporation, the objective of earning a profit is broadly defined. The power to reacquire and reissue its own shares is now specifically granted to the corporations by all the 50 states.[39] This means that a corporation is legally permitted to buy and sell its own shares after they have been issued to the original shareholders. Shares that have been reacquired by a corporation are treasury shares, and all transactions by a corporation in its own outstanding shares are treasury stock transactions.

While the legal characteristics of treasury stock are discussed in Chapter IV, a non-technical definition is useful here:

> Treasury stock is stock that has been issued as fully paid and non-assessable and has come back into the possession of the issuing company by purchase, gift, or otherwise, and is kept alive in the corporation treasury. It is issued but no longer outstanding stock. Unissued stock, whether or not reserved for a particular purpose, is not treasury stock. The term "treasury stock" is properly used to designate only the shares of its own stock which a company has acquired and which are held subject to disposal by its directors or its stockholders.[40]

The most significant points of this definition are:

(1) Treasury stock is a corporation's own stock.

(2) The stock has been issued and fully paid, and therefore was outstanding before being acquired by the corporation. The term does not apply to unissued shares.

(3) Treasury stock is stock that has not been cancelled after reacquisition, but is held "alive".

Treasury stock may be acquired by gift, in settlement of a debt, or by purchase. If acquired by purchase, the shares may be paid for with cash or non-cash assets, or with other securities of the acquiring corporation. The emphasis in this study will be on shares reacquired for cash. The acquisition of shares by gift involves no particular problem, since the corporation gives up nothing in exchange for the share, and the donor presumably made the gift willingly. All remaining shareholders share pro rata in whatever benefit accrues from the gift, and the shares, once acquired, are no different from shares reacquired by other methods.[41] Although the acceptance of shares in settlement of a debt may be an economic necessity at times, a reacquisition of shares in this manner is not a normal part of deliberate financial policy. When shares are paid for with non-cash assets, a problem of valuing the non-cash assets is introduced. This problem is not peculiar to the stock reacquisition transaction, but arises in every

transaction involving non-cash assets. To include it here would add nothing to one's understanding of the ramification of the reacquisition transaction per se. When the corporation issues other securities in exchange for its shares, the problem of valuation of the new securities is introduced and again the problem is not peculiar to the reacquisition transaction per se. Even though an exchange of new securities for outstanding shares of the corporation may change the status of the transaction with respect to the registration requirement of the Securities law, that changed status pertains to the issuance of securities and not to the reacquisition of the shares. Hence, little would be added to the examination of the reacquisition transaction by including the problems of the issue of the securities used to acquire the outstanding shares.

In this study, the term "shares" or "stocks" refers exclusively to common shares. Technically, a reacquisition of preferred shares that are not cancelled constitutes a treasury stock transaction. However, because preferred shares differ in an important way from common shares, reacquisition transactions in preferred shares have been excluded from the scope of this study.[42] A reacquisition of common stock may affect the proportionate claim of shareholders to earnings, to voting control, or to residual assets in case of liquidation. In the case of a reacquisi-

tion of preferred shares, there are few or none of those affects which occur in a reacquisition of common shares. This difference arises from the fact that, normally, a preferred stockholder has no voting rights, his claim to earnings is limited to the promised dividend and his claim against assets is fixed in amount.

IV - The publicly-held corporation: ownership and control.

Although a corporation has certain powers and is recognized as a legal person, it is not a human being and therefore is incapable of making a decision or acting for itself; its only means of doing these things is through individuals or groups of individuals. Shareholders do not act directly for the corporation. Rather, a corporation is managed by a board of directors chosen by the shareholders. To the board of directors falls the decision-making and managerial responsibility of the corporation. In respect to control and operation, therefore, the corporate form involves three distinct parties; the owners who contribute the basic resources in return for a residual interest in the corporation and the power to appoint its managers; the corporation itself, a fictitious being with certain powers, and the board of directors, the actual managers of the organization--"management". Throughout this study the distinction between these three parties will be significant. An overt act of the corporation--the treasury stock trans-

action--will be examined. It will be assumed that the primary objective of the transaction was an expected economic benefit. Though the action be that of the corporation, the decision was made by human beings--its management.[43] Nevertheless, the transaction is an act of the corporation, and the assets of the corporation are affected; however, the expected benefit may accrue not to the corporation, but to its stockholders or to management. This raises a question regarding the relationships among these three parties.[44]

This study is restricted to publicly-held corporations whose shares enjoy a widespread ownership and are publicly traded. In such cases, ownership and control are separated, with the result that the management group and the shareholder group are not identical. Shareholders are not directly involved in the operations of the corporation, and are forced to rely upon management for information as well as for sound managerial decisions; management--the directors--have a fiduciary responsibility to conduct the affairs of a corporation for the benefit of its absentee owners. The closely-held corporation differs from the publicly-held corporation so significantly as to justify the exclusion of the former from the scope of this study. Close corporations are almost identical with partnerships except for their limited liability feature; their shares do not enjoy a ready market, nor is such a market desired or intended.[45] Two characteristics of close-corporations are particularly significant; the first

is the provision that allows a negation of majority rule--in effect, the shareholders may, by contract, eliminate the one-share-one-vote rule. The other is the ability to restrict the transferability of shares.[46] These characteristics of a close corporation create problems peculiar to that form of organization, but they do not involve the problem of the appropriate relationship between corporation, management and shareholder where those parties are separate and distinct.

The following passage presents the characteristics of the close corporation, and by contrast, emphasizes the characteristics of the publicly-held corporation which will be the concern of the remainder of this study.

> ...it is recognized that the business corporation performs at least two distinct economic functions. First, it enables skilled entrepreneurs to enlist large masses of capital which they employ to the advantage of the absentee owners. Here we may have the publicly-owned corporation, the wealth and importance of which may exceed that of many of the states. Secondly, it enables the small partnership or single trader to personify its business and to separate its assets and liabilities from those of its members. Here we have...the close corporation...In some respects, the needs of the two types differ. The public corporation needs centralized management distinguished from the owners. In the private or close corporation this may not be needed or desired, since often the same persons are both managers and shareholders, with no clear distinction separating one capacity from the other. The idea that they must act as fiduciary directors for the benefit of themselves as passive beneficial owners will

> strike them as legalistic nonsense. Again, in the public company the shares of stock must be freely transferable, for the so-called "owners" demand a liquid investment. In the close corporation this is not likely to be wanted any more than it is in a partnership. The incorporators want to continue as partners albeit with the advantages of corporate personality; they do not want other people to be able to step into the shoes of their co-partners.[47]

Footnotes

1. See for example, Harry G. Guthmann and Herbert E. Dougall, Corporate Financial Policy (3rd ed.; New York: Prentice-Hall, Inc., 1955), pp. 693-695.

2. For instance, "...stock may be selling in the market for such a low price that it yields more than any new property they might acquire." Ibid., p. 694; (emphasis my own). No attempt is made to define that price, nor to indicate how the yields on reacquisition and new property would be compared.

3. Probably the best discussion of this kind, see William A Paton, and William A. Paton, Jr., Corporation Accounts and Statements (New York: The MacMillan Company, 1955), pp. 182-212. For a "how to account for" orientation, see H.A. Finney and Herbert E. Miller, Principles of Accounting, Intermediate (5th ed.; Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1958), pp. 145-156.

4. Ray Garrett, "Capital and Surplus under the New Corporation Statutes", Law and Contemporary Problems, XXIII (1958), pp. 239-263.

   Harry Buttimer, "Statutory Influence on Treasury Stock Accounting", Accounting Review, XXXV, No. 3 (July 1960), pp. 476-481.

5. "Shareholder's Right of Pre-emption in Treasury Shares", Yale Law Journal, XXXVI (1926-27), pp. 1181-1182.

6. "Buying out Insurgent Shareholders with Corporate Funds", Yale Law Journal, LXX (1961), pp. 307:321.

7. Paul K. Kirkpatrick, "Tax Consequences of a Corporation Dealing in its own Stock", XIII, Tulane Tax Institute 85 (1964).

8. Walter A. Holt and Edwin L. Morris, "Some Aspects of Reacquired Stock, 1931-1933," Harvard Business Review, XII (July 1934), pp. 505-510. They concluded that the two major factors underlying the repurchases that occurred during that period were a decline in the level of security prices combined with an excess of working capital caused by the reduced volume of business (p. 507).

9. This conclusion is supported by Wilbur A. Rapp, "The Role of Reacquired Common Stock in Financial Management", (unpublished Ph.D. dissertation, Graduate School, Northwestern University, 1966), p. 11.

10. See for instance, Harold Bierman, Jr., and Richard West, "The Acquisition of Common Stock by the Corporate Issuer", The Journal of Finance XI, No. 4, pp. 687-696. Also Edwin J. Elton and Morten J. Gruber, "The Effect of Share Repurchases on the Value of the Firm", The Journal of Finance, XXIII, No. 1, pp. 135-149.

11. "Rule 10b-5 and Purchase by a Corporation of Its Own Shares", Northwestern University Law Review, LXI, No. 2 (May-June 1966), pp.

12. David S. Ruder, "Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur", Northwestern University Law Review, LXI, No. 6 (January-February 1967), pp. 874-906.

13. Maurice L. Zilber, "Corporate Tender Offers for Their Own Stock: Some Legal and Financial Considerations", University of Cincinnati Law Review, XXXIII (Summer 1964), pp. 315-380.

14. Robert A. Kessler, "Share Repurchases under Modern Corporation Laws", Fordham Law Review, XXVIII (1959-60), pp. 637-688.

15. This is not unexpected, since the right of the corporation to reacquire its shares is firmly established in the United States, as evidenced by the fact that the corporation statutes of every state now explicitly empower the corporation to do so. However, an interesting exception is an article by Levy, published in 1932, and which is rarely, if ever, referred to by authors in this area.

See Irving J. Levy, "Purchase by a Corporation of Its Own Stock", Minnesota Law Review, XV (December 1930), pp. 6-33.

16. Leo A. Guthart, "Corporate Repurchase of Already Outstanding Common Stock", (unpublished D.B.A. dissertation, Graduate School of Business Administration, Harvard University, 1966). This work is summarized in an article by the same author, "More Companies are Buying Back Their Stock", Harvard Business Review (March-April 1965), pp. 40-43.

    Wilbur A. Rapp, "The Role of Reacquired Common Stock in Financial Management", (unpublished Ph.D. dissertation, Graduate School, Northwestern University, 1966).

    Richard R. Stevenson, "The Reacquisition of Corporate Stock", (unpublished Ph.D. dissertation, Graduate School, Michigan State University, 1966).

    Allan Edward Young, "Managerial, Market and Investor Problems Associated with the Case Tender Offers of Corporations for Their Own Common Stock", (Ph.D. dissertation, Graduate School of Business Administration, Colubmia University, 1967).

17. In the conclusion to the study he states, in part, "Financial management is concerned with (1) capital budgeting which certainly must include the sale of assets and the repurchase of common stock." (Emphasis mine), Rapp, p. 253.

18. Stevenson, p. 1.

19. Ibid., p. 5.

20. Ibid., p. 124.

21. Stevenson, dissertation abstract.

22. Young, p. 44.

23. Ibid.

24. Ibid., pp. 64-209.

25. Ibid., throughout the discussion, but especially pp. 210-268.

26. Rapp, p. 64.

27. Guthart, dissertation, p. 99.

28. Rapp, p. 64.

29. Guthart, dissertation, p. 115.

30. Stevenson, p. 312.

31. There were only two other years since 1933--1935 and 1938--where the aggregate amount of equity exceeded the aggregate amount of equity issued. These figures for retirements and issues do not coincide completely with the figures in Table 1 because they include preferred stock and are "net change" figures. Rapp, p. 45.

32. Stevenson, p. 14.

33. Young, p. 3. Of course, this alone need only mean an increased use of the tender offer method rather than in reacquisitions in total, but Young interprets this to indicate an increase in reacquisition.

34. Leo A. Guthart, "Why Companies are Buying Back Their Own Stock", Financial Analysts Journal, XXIII, No. 2 (March-April 1967), pp. 105-110.

35. Edwin J. Elton and Marten J. Gruber, "The Effect of Share Repurchases on the Value of the Firm", The Journal of Finance, XXIII, No. 1 (March 1968), pp. 135-149.

36. To the author's knowledge, no statistical study of reacquisition activity in the more recent period has been made, and data are not readily available in a form comparable to that cited above.

37. Dewing distinguishes three other types of corporation by the purpose for which they are organized:

    (1) Municipal corporations representing towns and cities chartered to attain continuity of existence.

    (2) Religious corporations which create an entity to hold assets separate from the members of the religious community.

    (3) Charitable, educational and scientific groups, where the corporation is merely the legal instrument for the common purpose, and provides continuous succession.

Arthur Stone Dewing, The Financial Policy of Corporations, (2 Vols.; 5th ed.; New York: The Ronald Press Company, 1953), p. 29.

38. Dow Votaw, Modern Corporations (Englewood Cliffs: Prentice-Hall, Inc., 1965), p. 12.

39. ABA-ALI Model Bus. Corp. Act, Sec. 5.

40. Jules I. Bogen (ed.), Financial Handbook (4th ed.; New York: The Ronald Press, 1964).

41. But see Chapter VII below where reacquisition by gift and in settlement of a debt are considered.

42. This approach is supported by other authors dealing with "treasury stock"; they simply ignore preferred share reacquisition completely. See for instance the literature reviewed in Chapter II.

43. The Courts have explicitly recognized this aspect of corporate operations; "...the fact must constantly be kept in view, that the metaphysical entity (the corporation) has no thought or will of its own; that every act ascribed to it, emanates from and is the act of the individuals personated by it; and that it can no more do an act, or refrain from doing it, contrary to the will of these natural persons, than a house could be said to act independently of the will of its owner; and, where an act is ascribed to it, it must be understood to be the act of the persons associated as a corporation." Ohio St. 137 (1892), cited by Dewing, p. 19.

44. An excellent example is the case where the corporation reacquires its shares to enhance or protect the control position of the controlling shareholders. Theoretically, the objective is that of the corporation, and yet the corporation is by nature unconcerned with its ownership. The benefit is that of the controlling group, but it is the corporation entering into the transaction, and it is the assets of the corporation utilized in the transactions. It is the directors as shareholders, causing the corporation to act, and it if for the benefit of some, but not all, of the shareholders. This potential conflict of interests among these parties is confirmed by the existence of laws providing for the "derivative suit", whereby the shareholder may bring suit against the directors, on behalf of the corporation. This is discussed at length below, in Chapter VII.

45. F. Hodge O'Neil, "Developments in the Regulation of the Close Corporation", Cornell Law Quarterly, V (Summer 1965), pp. 644-651.

46. Many corporation statutes contain provisions which permit adaptation to the need of the closely-held enterprise. Four states--New York, North Carolina, South Carolina and Florida--explicitly recognizing the peculiarities of this type of organization, have recently passed legislation specifically applicable to close corporations. O'Neil, p. 644.

47. Ralph J. Baker and William L. Cary, Cases and Materials on Corporations (3rd ed.--abridged; Brooklyn: The Foundation Press Inc., 1959), pp. 13-14.

CHAPTER III

The financial or economic effect on the corporation.

This chapter deals with the nature of the treasury stock transaction and with the problem of measuring the effect of such transactions on the corporation and on shareholders.

I - The nature of the transaction.

When shares are issued for consideration, two things occur:

(1) the number of shares outstanding is increased, and

(2) the total assets of the corporation and the total shareholders' interest in the corporation are increased.

The extent of the increase in total assets and in the total shareholders' equity is a function of the issue price of the shares and of the number of shares sold. This statement applies to a reissue of treasury shares as well as to an issue of new share. There is noth-

ing intrinsically peculiar, in the financial sense, in the reissue of treasury shares as compared to the issue of new shares. From the viewpoint of the direct effect on assets, shareholders' equity and shares outstanding, the reissue of treasury shares is identical with the issue of new shares.[1]

When shares are reacquired for consideration,

(1) the number of shares outstanding is reduced, and

(2) the assets of the corporation and the equity of the shareholders in the corporation are reduced to the extent that corporate assets are distributed in the act of acquiring the shares.

The reacquisition of shares constitutes a distribution of assets, and is essentially the opposite of the raising of capital by the issue of shares.[2] When shares are issued, the assets and the shareholders' equity are increased; when shares are reacquired, the assets and shareholders' equity in the corporation are reduced by the amount of assets returned to the shareholders. In reacquiring its shares, a corporation does not acquire an asset,[3] and it is inappropriate to speak of the reacquisition of shares as "investing in treasury shares".[4] Not only does the

repurchase of shares not constitute investment but it amounts to a distribution of assets, thereby rendering those assets unavailable for future investment by the corporation. This aspect of the problem is discussed further in Chapter VII.

II - The effects of the transaction.

The actual effects of a given reacquisition on the corporation and its shareholders is a function of several factors which together determine the extent of the attendant reduction in assets, shareholders' equity and share outstanding. These factors are:

(1) the price paid for the shares,

(2) the rate of earnings on the assets distributed and on all assets,

(3) the capital structure of the firm, and the effective cost of non-equity capital to the firm,

(4) the earnings per share before reacquisition,

(5) the book value per share before reacquisition.

The following discussion will explain the effect of the above factors, and of the attendant reduction in assets and shares outstanding. In theory, a distinction should be drawn between the effect on the corporation and the effect on the shareholders, and between the nature of the effects and the measurement of the effects. In fact, these distinctions are not strictly adhered to, since to do so would make the discussion cumbersome and repetitious. Furthermore, the con-

cepts used in the discussion of these effects are common ones, employed in their common usage.

A. The reduction in the number of shares outstanding:

There are several aspects of this reduction which are touched on lightly here but are discussed in greater detail later.

(1) The number of claims against the assets and to the residual income of the corporation are reduced. Whatever the earnings of the corporation, they are subject to division among fewer shareholders; this is significant in calculating earnings per share. In the same way, the assets of the corporation are subject to the claims of fewer shareholders; this is reflected in the calculation of book-value per share.

(2) The voting control of the corporation is affected.[5] Treasury shares do not have the right to vote nor are they counted for purposes of determining a quorum or consent of shareholders.[6] Since treasury stock is not voted, it does not count in the election of directors. However, treasury stock has voting significance since the total number of shares is reduced by a reacquisition and this increases the percentage weight of each share outstanding. As will be seen below, in some cases the objective of a reacqui-

sition is the protection or enhancement of the control position of certain shareholders.[7]

(3) If the number of shares outstanding is reduced, dividend requirements are reduced; this means that it will henceforth require a smaller amount of assets to pay dividends at a given rate.

(4) A reduction in the number of shareholders may result from the reacquisition of shares. This may simplify the problem of corporate-shareholder relationships, and may reduce the cost of keeping track of and communicating with shareholders especially if the shares are acquired from small stockholders.[8]

B. The reduction in corporate assets:

(1) Reduction in total assets and earnings. The total assets of the corporation will be reduced by any reacquisition of shares for consideration. Unless the distributed assets were earning a negative rate of return, this will cause a decline in the total earnings of the corporation. The extent of decline in total earnings is, for a given reduction in assets, a function of the rate of earnings which would have been realized on the distributed assets; the greater the earnings on the distributed assets, the greater the reduction in corporate earnings.

If the rate of earnings on the assets distributed

was less than the average earned on total assets, then the distribution of these assets will increase the average rate of earnings on the remaining assets; if the rate is above the average, then the average will be decreased.

In discussing the effects of reacquisition in terms of total assets, total earnings, and rates of return, several points should be noted. First, the effects apply to the corporation with no necessary attendant effects on the interest of a shareholder. The analysis is in terms of total income, and of rate of return on total assets employed; no recognition is made of the number of shares outstanding -- this is not a calculation of earnings per share (hereinafter eps) -- and the price paid per share does not enter into the calculation. When price per share enters the calculation, the emphasis is on the impact on the interest of the shareholder. The effect on the corporation of a reacquisition is purely a function of the assets distributed and the earnings foregone thereby.[9] It follows that this effect is not a function of eps, or dividends per share, of price paid for each share, or of the price/earnings ratio.

Secondly, in evaluating the effect of a reacquisition -- as against retention -- the relevant rate of earnings to be considered is that rate which would have been earned on the assets had they been retained and employed in their best alternative use. This is not necessarily the rate that was being earned on the funds before reacquisition.

Thirdly, the effect attributed to reacquisition should be only that effect caused directly by reacquisition, as against retention. For example, if an unprofitable division of a company is sold and the proceeds used to reacquire shares, the total earnings of the corporation will be increased. This increase in earnings is due to the disposal of the unprofitable division and not to the reacquisition. Had the funds been retained at <u>any</u> rate of earnings above zero, then the total earnings would have increased, relative to what they were with the reacquisition. In the same way, where treasury shares are used in acquiring another corporation, (or assets in any form), the proper evaluation of the use of treasury shares requires an evaluation of the relative effect of acquiring by the use of treasury shares as compared to acquiring by some other method -- i.e., cash or previously unissued shares.[10]

(2) Change in capital structure: If debt is present in the corporation's capital structure, the distribution of assets will <u>reduce</u> the proportion of equity capital in the structure. This will reduce the protection afforded creditors by corporate assets and earnings, a fact recognized by the provisions in corporation statutes which place restrictions on stock reacquisition. This fact may cause a change in the market value of the firm's shares, and in the future cost of debt to the firm, if the market should alter its view of the corporation's risk characteristics. The change in the

market's evaluation of the corporation's risk characteristics may result in a change in the cost of capital to the corporation. The potential effect on the corporation's cost of capital is a result of the impact of the reacquisition on the leverage[11] inherent in the financial structure, as well as the change in risk characteristics. The extent of leverage in a corporation's financial structure is a function of two factors:

(a) The proportion of equity in the capital structure; the smaller the proportion of equity, the more highly levered is the structure. A reacquisition of shares causes a reduction in the proportion of equity capital in the structure and increases the extent of leverage.

(b) The difference between the average rate of return earned on all assets and the effective cost of non-equity capital; the greater this difference, the greater the leverage.[12]

A stock reacquisition will cause a change in this difference if the average rate of earnings on all assets is thereby changed. The effect on the average rate depends on the relationship between this rate, and the rate of earnings on the assets distributed. If the rate of earnings on distributed assets is below the average rate earned on all assets,

then the average rate will be increased. This will increase the difference between the average rate and the cost of non-equity capital, and will thereby increase the extent of leverage in the capital structure. The converse is also true; if the rate of earnings on all assets is below that of the cost of non-equity capital, (a state of "reverse leverage"), then the conclusions cited above must be reversed. As the average rate rises, the extent of leverage will be reduced, until the average rate is equal to the cost of non-equity capital; beyond that point, the extent of leverage will increase.

It should be noted that the effect of leverage is measured in terms of the rate of return to equity, and not in terms of earnings per share. There is no necessary relationship between the effect of a reacquisition on the rate of return to equity and the effect on earnings per share. The impact of a given reacquisition on earnings per share, is ceteris paribus, a function of the price paid for the shares. The impact of a given distribution of assets on the rate of return to equity is a function of the foregone return on those assets. It is totally unrelated to the number of shares reacquired in return for those assets.

(3) The effect of a reacquisition of stock on book-value per share: The sole determinant of the impact on book-value per share is the price paid for the shares. If the price paid is less than the book-value per share before

reacquisition, then the book-value will be increased; if the price paid is more, then the book-value will decrease.

If the effect of reacquisition were to be judged solely on the basis of its impact on book-value per share, the determination would be simple. The effect would be favorable -- the book-value per share would be increased -- whenever the shares are reacquired at a price less than the book-value per share before the reacquisition, and unfavorable whenever the price paid was more than the book-value. However, the effect on book-value is not a meaningful measure of the effect of reaquisition on the interest of a shareholder.

Book-value is generally regarded as an inadequate measure of the value of the corporation. In accordance with the generally accepted accounting principle that assets be valued at original cost, no attempt is made to reflect in the balance sheet the value of the corporation as a going concern. Individual assets are valued at their original cost, with no attempt to reflect either the current value of the individual assets, or the value of the firm as a whole. Accordingly, the book-value of the firm's assets bears no necessary relationship to the earnings expected from individual assets, or from the entire firm, and bears no necessary relationship to the real value -- based on expected future earnings -- of the firm.[13] It follows that a change in the book-value of corporate assets does not imply a proportionate, or any, change in corporate earnings or value. There is no necessary rela-

tionship between book-value and earnings, or between a change in book-value and a change in earnings. This inadequacy has led to the wide acceptance of earnings as a factor in determining the value of the corporation, and of earnings per share as a determinant of the value of the share. The effect on eps will be discussed next, and the relationship between book-value and earnings considered below with the aid of examples.

(4) The effect on earnings per share: Earnings are now generally accepted as the basic determinant of the value of the corporation, in accordance with the economic theory which defines the value of an asset as the present value of the future stream of income generated thereby. Reported earnings are used as an indicator of the nature of the future stream of income, and a change in earnings, ceteris paribus, is viewed as an indication of a change in the value of the corporation. In the same way, the value of a share is, ceteris paribus, a function of the earnings per share, and a change in earnings per share is taken to indicate a change in the value of that share.

Earnings per share is probably the best single indicator of the value of a share available to the shareholder or investor. This statistic is disclosed in corporate annual reports, in news releases, in the reports of the financial services, and in reports of investment analysts. The market price of stocks is discussed by the investment community in

terms of a multiple of such earnings per share. All other things being equal, investors view an increase in eps as suggesting an increase in the value of the share.

Inasmuch as earnings per share is calculated as total corporate earnings divided by the number of shares outstanding, a reacquisition has a direct effect on eps since it induces changes in one or both of the factors. (Precisely defined, the change in eps is equal to the ratio of the relative change in earnings to the relative change in the number of share outstanding.)

Since corporate earnings are causally related to the amount of corporate assets, it follows that any distribution of assets is going to affect aggregate corporate earnings to some extent. When a given number of shares are reacquired, the amount of assets distributed depends on the price paid for the shares by the corporation. (Alternately, for any given distribution of assets, the reduction in the number of shares outstanding is determined by the price paid per share.) It follows that the impact on eps of a stock reacquisition is a function of the price paid for the shares; the higher the price paid, the less favorable the impact on eps.

The impact on eps is also a function of the rate of earnings on the assets distributed. The higher the rate of earnings on the assets distributed, the greater the reduction in total corporate earnings as a result of the reacquisition.

It follows that the higher the price paid for the shares and the higher the rate of earnings on the distributed assets, the greater the reduction of assets and income for a given reduction of the number of shares outstanding and the less favorable the impact on eps. The converse is also true; the lower the price paid for the shares and the lower the rate of earnings on the assets distributed, the more favorable the impact on eps.

These relationships can be more rigorously stated and the variables quantified to predict the effect on eps of a reacquisition of shares. For any given case, the corporation's eps and the earnings' rate on its various assets is given. In considering the effect of a potential stock reacquisition, the price paid for the shares becomes the independent variable. A useful relationship between share price and the rate of earnings on distributed assets can be established by restating the share price as a multiple of eps, using the price-earnings ratio. The reciprocal of the price/earnings ratio, expressed as a percentage, is the rate of discount applied to the per share earnings; this rate is implicit in the relationship between the eps and the share price.[14]

Since, in any given case, the eps before reacquisition is given, prices can be expressed as rates of discount. Different prices will represent different relationships between the rate of discount and the rate of earnings on the

distributed assets. The impact of a reacquisition on eps under various relationships between these rates can be expressed as a simple formula, and will be examined using an example.[15]

The earnings per share before reacquisition can be expressed as $\frac{E}{S}$,

and the eps "after" as $\frac{E - Di}{S - Dr(\frac{S}{E})}$, where

E = total earnings before reacquisition

S = number of shares outstanding before reacquisition

D = assets distributed in reacquisition

r = the reciprocal of the price/earnings ratio

i = the rate of earnings on the assets to be distributed

It can be shown that[16] if r = i, then the eps will be unchanged by virtue of the reacquisition. Similarly, if r > i, then the eps will be increased, and if r < i, eps will be decreased by virtue of the reacquisition. Since r is the reciprocal of the price/earnings ratio, the higher the price, the lower the value of r. As would be expected, the higher the price paid for the shares, the less favorable the impact on eps (or more accurately, the smaller the probability that the impact on eps will be favorable). An example is useful:

Assumed data:

Total corporate assets	$1,000,000
S = shares outstanding before	100,000

E = total earnings before $ 200,000

E/S = eps before 2.00

s = number of shares to be reacquired 10,000

Table 2 presents specific cases of the general formula given above. The following values are common for all parts of the table:

E = $200,000

S = 100,000

s = 10,000

r = 5.00, 6.67, 10.00, 12.50 and 20.00%

Parts a, b, and c of the Table differ in the value assigned to i, with a, b, and c assuming values of 10%, 5% and 20% respectively. The formula can be used to solve for any value of eps "after" -- i.e., from Table 2, part c, line 4, where r = 12.5%.

$$\text{eps after} = \frac{E - Di}{S - Dr\left(\frac{S}{E}\right)}$$

$$= \frac{\$200,000 - (\$160,000)(.20)}{100,000 - (160,000)(12.5)\left(\frac{100,000}{200,000}\right)}$$

$$= \frac{200,000 - 32,000}{100,000 - (160,000)(12.5)(.5)}$$

$$= \frac{168,000}{100,000 - 10,000}$$

$$= \frac{168,000}{90,000}$$

$$= 1.87$$

TABLE 2.

The effect on eps of reacquisition as a function of the variables E, S, s, i, r

E = $200,000
S = 100,000
s = 10,000
eps before = 2.00

Price per share	Price/ earnings ratio	r	(a) i = 10% eps after	(a) i = 10% change (decrease)	(b) i = 5% eps after	(b) i = 5% change (decrease)	(c) i = 20% eps after	(c) i = 20% change (decrease)
$		%	$	$	$	$	$	$
40	20	5.00	1.77	(0.23)	2.00	- 0 -	1.35	(0.65)
30	15	6.67	1.88	(0.12)	2.05	.05	1.55	(0.45)
20	10	10.00	2.00	- 0 -	2.11	.11	1.77	(0.23)
16	8	12.50	2.04	.04	2.13	.13	1.87	(0.13)
10	5	20.00	2.11	.11	2.16	.16	2.00	- 0 -

This forumla, which makes it possible to predict the effect on eps of a reacquisition, will be used in Chapter VII in the discussion of the objectives of reacquisition. What is important at this point is the relationships which can be demonstrated with the aid of the formula and Table 2 based thereon.

Table 2 demonstrates the effect on eps of the various relationships between discount rate and earnings rate. In part (a) of the table, earnings rate on assets is given as 10%; when the discount rate is higher than 10% (at prices of $16.00 and $10.00 per share), then the eps is increased by the reacquisition. When the discount is 10%, (the same as the earnings rate), there is no impact, and when the discount rate is lower, the eps will be decreased, (at prices of $40 and $30 per share). Where $r > i$, the effect on eps is favorable; where $r < i$, unfavorable, and where $r = i$, the effect is zero. In parts (b) and (c), i is set at 5% and 20% respectively. In part (b) (where $r \geq i$ in all cases), there is no case where eps is reduced by the reacquisition. In part (c), (where $r \leq i$ in all cases), in no case is eps increased. In part (a), eps is increased where $r > i$, decreased where $r < i$.

The relationship between r and i, and the effect on eps thereof, has considerable practical significance. At any point in time where the market price of shares is such that $r > i$, the corporation can increase its eps by reacquiring

shares at that price. Also, the higher the value for i -- the higher the rate of earnings on assets available -- the lower the price at which the shares must be available to make reacquisition desirable. Alternately, given a "low enough" value for i, the price can be relatively high and still render reaquisition desirable. This has, of course, been recognized as evidenced by the general position that firms with idle capital should consider the repurchase of their own shares -- the idle capital indicating an expected low future level for i. This may also have been effectively utilized, although possibly for the wrong reasons, when corporations buy their shares because the market value is so low as to make them a "good value".

The point will not be pursued further here[17] but it should be recognized that this analysis which is based on the impact of reacquisition on eps, is simply the application in reverse of the determination of the cost of equity capital. Where the cost of equity capital is based on the effect on eps, the decision rule is based on the relationship between r and i. When deciding whether to issue additional equity capital, the issue will be indicated as desirable where i_1 -- the return available on the capital if raised -- is greater than r, the e/p ratio.

As has been indicated above, the reacquisition is simply the reverse of capital raising. Accordingly, to justify distribution, rather than raising, of capital, it is

necessary that $r > i$, rather than $r < i$.[18]

(5) The reacquisition of shares as an investment: The invalidity of considering the reacquisition of shares as a corporate investment will be considered later. However, the concept can be easily integrated into the present analysis at this point. The general formula for determining eps after reacquisition was given as $\frac{E - Di}{S - Dr(\frac{S}{E})}$ and it was shown that eps would increase if $r > i$, decrease if $r < i$ and be unchanged if $r = i$. There i was defined as the rate of earnings that would be earned on the funds if they were not distributed. If i is defined to be the highest return available if the funds are not distributed, then reacquisition can be compared with other opportunities for "investment" on the basis of the impact on eps.[19]

This is the general case of the reacquisition problem. At any time, the reacquisition decision would be made by comparing the discount rate implied in the share price, and the rate of earnings available in the best use of the assets to be distributed. By using the present (actual or historical) rate of earnings on these assets, this implicitly assumes that no better alternative use of these assets is available.

An example is helpful:

Assume the conditions used previously:

$$S = 100,000$$

$$E = \$200,000$$

$$s = 10,000$$

$$\frac{E}{S} = \$2.00$$

Also assume r = 20%.

Now define i_1 as the return available if the funds are retained, in the form of marketable securities yielding 10%. Define i_2 as the return available on the best available investment project at 30%, requiring an investment of $100,000. Based on the decision rule, $r > i_1$, (20% > 10%), therefore, the eps will be greater if the $100,000 is used for reacquisition than if the funds are invested at 10%. Further, since $i_2 > r$, (30% > 20%), eps will be greater if the investment opportunity is accepted than if the shares are reacquired. This can be proven with the aid of the formula.

If the assets are invested at 10%, the eps will be $2.00. (This is given above.)

If the shares are reacquired, then

$$\text{eps} = \frac{\$200,000 - (\$100,000)(.1)}{100,000 - (100,000)(.2)(.5)}$$

$$= \frac{200,000 - 10,000}{100,000 - 10,000}$$

$$= \frac{\$190,000}{90,000}$$

$$= \$2.11$$

If the investment opportunity is accepted, then the shares outstanding will remain at 100,000.

The income will be	$200,000
Less earnings on assets now invested in project	10,000
	$190,000
Plus return on new project (30% x 100,000)	30,000
	$220,000

This results in eps of $\frac{\$220,000}{100,000}$ or $2.20.

The results of the three alternatives are as follows:

No reacquisition, no investment, (i_1 = 10%)	eps = $2.00
Reacquisition (r = 20%)	eps = $2.11
No reacquisition, investment, (i_2 = 30%)	eps = $2.20

Thus, the effect on eps of reacquisition was favorable, but less so than investment in the available project would have been.

(6) The relationship between effect on book-value and on eps: The above examples shed light on the validity of change in book-value as a measure of the effect on the equity of the shareholders. In Table 2, book-value per share was $10.00 and at prices above $10.00, book-value was decreased, and at prices below $10.00, book-value was increased. The statement is encountered that it is beneficial for a corporation to purchase its own shares when they are available at a price below book-value, implying that it is beneficial purely because the price is less than book-value.[20] This implies that it would never be beneficial for a corporation to buy its

own shares at a price above book-value, and that it would always be beneficial to buy at a price below book-value. This is valid if benefit is calculated only in terms of effect on book-value. However, it completely ignores the impact on eps, since it does not recognize the determining influence of the rate of return on distributed assets.

Note that in part (a) of Table 2, purchases at book-value ($10) or above book-value (at $16) increase eps. In part (b), where the earnings rate is only 5%, purchases at book-value and above (up to $40, 4 x book-value) increase the eps. In part (c), where the earnings rate is 20%, all purchases above book-value cause a decline in eps. Furthermore, if the assumed rate of earnings were 30%, a purchase of shares at book-value would cause the eps to decline and with a higher rate of earnings, purchases of shares below book-value would cause eps to decline.

While there are no necessary relationships between the effect on book-value and on eps, some generalizations can be made: While a reacquisition below book-value is likely to have a favorable effect on eps, this will not be the case if the rate of earnings on assets distributed is relatively high. Reacquisition at a price above book-value is less likely to increase eps, but will do so if the rate of earnings on distributed assets is relatively low. This is the normal[21] case because historically, price levels have risen, (rather than declined) and this has generally caused the book-values of

assets to be understated, relative to the value of those assets calculated as a function of earnings stated in current dollars.

(7) The effect on dividends: It is difficult to make many useful comments on the impact of a reacquisition on dividends. Since the number of shares outstanding is reduced, it will take a smaller amount of total earnings and assets to pay a dividend of the same amount per share. Insofar as dividends are a function of earnings, total dividends will be decreased in the long run since the assets distributed would presumably have earned some positive rate of return had they been retained. On a per share basis, if the reacquisition has a favorable effect on eps, it would be reasonable to expect that, insofar as dividends are a function of earnings -- in both the short and long run -- the dividends per share would be increased by the reacquisition. In the short run, the reacquisition is a distribution of assets, and may, therefore, reduce distributions on account of dividends from what they might otherwise have been.

(8) The effect of reacquisition on the interest of the shareholder: The total, net effect of reacquisition on the interest of the shareholder is a function of many factors, and given the state of development of the theory of corporation finance, is the subject of dispute. The total return to the shareholder includes dividends as well as the change in

market price of his shares. Because of income tax advantages, reacquisition may be employed as a distributive device instead of dividends. Insofar as the proceeds of reacquisition are not taxable as ordinary dividends in the hands of the recipient,[22] there is a net benefit to the total shareholder group by virtue of distribution via reacquisition rather than via an ordinary dividend.[23] Thus, reacquisition may directly affect the relative significance of dividends in determining the return to shareholders. Too, the reacquisition of shares by the corporation results in an increased demand for the corporation's shares, which may increase the market value of the shares relative to what it would otherwise have been. The practical significance of this, in any particular case, will be a function of numerous factors, the most important of which are probably the number of shares repurchased, the effective "float" of the share, the price paid, and the pattern of purchase. The potential effectiveness of such purchases has been recognized in the anti-manipulative provisions of the federal securities legislation.[24] Even short of manipulation, or price support, the corporation's buying may "make a market", or "deepen" the market, so as to allow a shareholder to sell his holdings in a more orderly market, although not necessarily at a higher price. There is vigorous debate on the basic question of the determinants of a share's market value. Earnings per share, dividends per share and various combinations of the two are actively supported by financial theorists.

Given the effect of reacquisition on corporate asset structure, capital structure, leverage, earnings and dividends, a decision would have to be made concerning the determinants of share value before the effect of reacquisition on the interest of the shareholder could be determined. If a decision were made as to whether earnings or dividends (or some combination thereof) were the determinants of share-value, there would still remain the question of the discount applied to the stream of earnings or dividends by the market. This discount rate reflects the market's assessment of the risk attached to the ownership of that share. This assessment may change because of the change in the asset structure. It is conceivable that the market might view the reacquisition as a distribution of the liquid assets, with the retention of those assets to which is attached a greater amount of uncertainty concerning the future earnings and asset value. The reduction in size of the total corporation may put it into a less favorable risk classification, due to reduced size alone. Alternately, the market might view reacquisition as an admission of inability to employ funds profitably, and, therefore, apply a higher discount to the firm's indicated earnings.

Where there is debt in the capital structure, the reacquisition will increase the proportion of debt capital in the structure. Given an increase in eps, there is dispute as to whether there will be a resulting increase in the market value of the share. Essentially, the reacquisition re-

sults in a more highly levered corporation, in the same way as the issue of additional debt capital. It is conceivable that the attendant change in the market's evaluation of the corporation's risk characteristics might act so as to partially, or completely, offset the favorable effect of the additional leverage. The nature, and degree of this change is the essential part of the dispute between the Modigliani and Miller (hereinafter M & M) and traditional theories of the cost of capital.[25]

It would be incorrect to leave the above discussion as it stands, since it implies that the total favorable impact on eps might be offset by changes in the market's evaluation. The M & M hypothesis fully applied would hold that only that portion of the increase in eps which is produced because of the increased leverage would be negated by the changed risk assessment. The M & M hypothesis would not properly include that increase in eps which is due to the fact that $r > i$. To say that the M & M hypothesis would have this increase negated by change in risk assessment would be equivalent to saying that the M & M hypothesis would negate the effect on market value of the share of an increase in eps because of investment of funds above the cost of capital -- that is, where $i > r$. It can be assumed that the market value of the share will, in the long run at least, reflect that part of the increase in eps which is due to the repurchase of shares under those conditions where $r > i$.

Footnotes

1. There is no intrinsic reason for, ceteris paribus, the issue price to be lower (or higher) on a treasury share than a new share. The rights of a purchaser of treasury shares are the same as those of the purchaser of new shares. While there are certain legal and regulatory factors involved, these would not be expected to affect the net issue price.

2. The fact that the reacquisition of shares by a corporation constitutes a distribution of assets is explicitly recognized in the corporation statutes, where the restriction on treasury stock transactions are formulated in terms of funds available for distribution--e.g., the "surplus rule". See the discussion in Chapter IV.

3. The economic nature of treasury shares is recognized by legal writers; "It is obvious that, although the selling shareholder has given up an asset, the corporation has not acquired one. Its own shares are of no value to it unless and until they are resold. What has actually happened is that the corporation's assets have been reduced by the amount paid for the shares...", Baker & Cary, p. 1052. The following works contain extensive discussions of the economic nature of treasury stock. William A. Paton and William A. Paton, Jr., Corporation Accounts and Statements, pp. 187-189; R.L. Dixon, Samuel R. Hepworth, William A. Paton, Jr., Essentials of Accounting (New York: The MacMillan Company, 1965), Maurice Moonitz and Louis H. Jordan, Accounting: An Analysis of Its Problems (2 Vols.; revised ed.; New York: Holt, Rinehart and Winston, 1964), II, p. 194; H.A. Finney and Herbert E. Miller, Principles of Accounting, Intermediate, pp. 145-148. It is now generally recognized in accounting literature that treasury stock does not constitute an asset. However, a case is made for considering as assets shares which are held to satisfy requirements of stock-option, purchase or bonus plans. For this position, see Finney and Miller, p. 146. For rebuttal, see Paton and Paton, p. 188.

4. See Guthart, "Why Companies Are Buying Back Their Own Stock", Financial Analysts Journal, XXIII, No. 2 (April-March, 1967), pp. 105-110.

5. This is discussed in Chapter V.

6. See discussion in Chapter IV.

7. See discussion in Chapter VI.

8. This is an objective of reacquisition, see Chapter VII.

9. In all cases where the rate of earnings on assets distributed was positive, the total earnings will go down, regardless of the effect on eps, which will be determined by the price paid for the shares.

10. See the discussion on this point in Chapter VII.

11. "Leverage", as used here, refers to the effect--on the relationship between the rate of return to equity and the rate of return on assets--of introducing non-equity (fixed charge) capital into the corporation's financial structure. For the sake of simplicity, a distinction need not be made between "leverage" and "trading on the equity" as is done by Pearson Hunt, "A Proposal for Precise Definitions of Trading on the Equity and Leverage", Journal of Finance, XVI, No. 3 (September 1961), pp. 377-386.

12. The significance of this point was best made explicit by Hunt, and Merwin H. Waterman, "Financial Leverage", Essays in Business Finance, Merwin H. Waterman, ed., (4th ed.; Ann Arbor: Masterco Press, 1963).

13. This is demonstrated in the case where the total earnings of the firm are improved by the disposal of a part of the assets which had been reporting a loss. Although reporting a loss, the assets probably had a positive book-value, which is essentially inconsistent with the indicated expected future lack of economic returns. It follows that after disposal, the firm's total earnings would increase --by the amount of the loss--even though with the smaller amount of assets employed. Equally significant, the fact that these "loss-assets" can be disposed of for a positive amount indicates the existence of value, regardless of the losses reported, and this value would only by coincidence be equal to the cost-based book-value. This suggests other aspects of the valuation problem, the first of which is that the reported losses themselves were based on a cost-based accounting, and probably not highly meaningful in real economic terms. The second is that assets may, and do, have different values to different owners, and that these differences can arise, rationally, for different reasons. The first source of difference is the fact that the real returns will differ to different users, because of the nature of the employment of the asset. Thus one firm "needs" -- can employ profitably -- a new truck, while another cannot. Alternately,

subjective evaluations placed on an asset are determined by the information available concerning the assets' operations, the adequacy of that information, the procedure followed in using this information to place a value on the asset. In short, different individuals can place a different value on the same asset in the same use, and this can be rationally defensible, insofar as no mechanism for infallible evaluation is readily available at present.

14. For example, assume a price of $10, eps of $2, and therefore, price/earnings ratio of 5. The reciprocal —1/5, represents a discount rate of 20% applied to a perpetual stream of earnings of $2, to get a present value of $10. In the same way, with eps given at $2, a price of $40 represents a price/earnings ratio of 40/2 or 20, the reciprocal is 1/20 and the "discount" rate is 5%.

15. This model covers the all-equity case only, thereby avoiding the complexities of debt and leverage considerations. A model could be developed which included this, and which would be of interest. However, the complexity would be considerable, and the model would not necessarily be useful in the context of the present discussion. The development of this model, and the proof of the relationships discussed below, are presented in Appendix II.

16. See Appendix II.

17. But will be pursued below in Chapter VII.

18. This is the all equity case, and the existence of debt capital in the structure would have to be recognized, with the effects of leverage operating in reverse.

19. It should be noted for future reference that the sole criteria is the impact on eps.

20. See discussion, Chapter VII.

21. This is not the case without exception: book-value may overstate the value of the asset, regardless of the fact that they are stated at original cost.

22. See Chapter V.

23. See Bierman and West, The Journal of Finance, XI, No. 4, pp. 687-696; and, Elton and Gruber, The Journal of Finance, Vol. XXIII, No. 1, pp. 135-149.

24. See Chapter IV (re the Georgia-Pacific case), and Chapter III.

25. See generally: Ezra Solomon, The Theory of Financial Management (New York: Columbia University Press, 1963); J. Fred Weston and Eugene F. Brigham, Managerial Finance (2nd, ed.; New York: Holt, Rinehart and Winston, 1966); Franco Modigliani and M.H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment", American Economic Review, XLVIII (June 1958), pp. 261-97; ....., "The Cost of Capital, Corporation Finance, and the Theory of Investment", American Economic Review, XLIX (September 1959), pp. 655-69; ....., "Corporate Income Taxes and the Cost of Capital; A Correction", American Economic Review, LIII (June 1963), pp. 433-4.

CHAPTER IV

The legal and regulatory status of treasury stock transactions.

The treasury stock transaction is subject to two distinct areas of regulation; corporation law and securities legislation. Since the transaction involves an action of the corporation, it falls within the jurisdiction of corporation law. Since the transaction involves trading in corporate securities, it also falls within the sphere of securities legislation. In the United States, corporation law is state law. There is no federal corporation statute as such. Incorporation is accomplished by compliance with requirements of a state corporation statute. However, a body of federal corporate law is developing in the form of administrative rules, rulings, and regulations promulgated by the Securities and Exchange Commission under authority given it by Federal statutes.[1] Accordingly, both corporation law and securities legislation contain provisions relevant to this study.

In general, state corporate statutes deal with the right of a corporation to reacquire its shares, and with limitations on that right. The federal securities law deals with the propriety of exercising the right in specific cases, and with the responsibilities of the corporation, its directors and various groups of shareholders. State Corporate statutes are creditor-oriented, while the federal securities

legislation is shareholder-oriented.

State corporation law is largely statute law, with the case law of lesser significance. A large number of corporate statutes have recently been revised,[2] embodying those parts of case law that have found general acceptance, and reducing the variation found among state statutes. The provisions of the Model Business Corporations Act,[3] (hereinafter the Model Act), will be used where an example of typical statute law is required. Attention will be given also to provisions of specific state statutes that differ to a material extent or in a manner which is noteworthy.

The Model Business Corporation Act is given major credit for statutory reform since most of the current state revisions have substantially followed the Act in whole or in part.[4] One-fourth of the American jurisdictions have already enacted the Act, and seven more have many similar provisions.[5] To a large extent, state statute law with regard to treasury share transactions follow the pattern set by the Model Act. In this regard, Kessler has said:

> "While statutory provisions may differ it is fair to say that none has been drawn up in ignorance of, and most have indeed been influenced by, section 5 of the so-called Model Business Act,...In fact, many are substantially identical to the Model Act section. Since the Model Act provision has already had such influence, and appears certain to have an even greater one on the nation's corporations' laws, it is fair to consider it as typical of the Modern American law on share acquisitions."[6]

Equally important for purposes of this study, the Model Act represents the studied position of the legal profession as represented by the American Bar Association.

I - The power of the corporation to deal in its own shares.

The corporate statutes of every state explicitly empower the corporation to reacquire its own shares,[7] but in all states, the right is subject to certain limitations. In general, the limitations are based upon a recognition of the fact that a repurchase of shares is essentially a corporate distribution of assets. Therefore they take the form of specifying which funds may be used or which funds may not be used to repurchase shares. With certain exceptions, funds are available for purchase of a corporation's own shares only to the extent of its legally defined surplus, or more specifically earned surplus, with insolvency as an additional general limitation. Some statutes, instead of permitting purchase to the extent of surplus, accomplish the same result by forbidding purchase if capital is impaired, or would be impaired, by the transaction. Exceptions usually exist in that purchase for certain purposes may be made without regard to impairment of capital.

A. The statutory provisions.

1. The surplus rule.

The Model Act is representative of the provisions

found in the statutes:[8]

> "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 purchase 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 at least two-thirds of all shares entitled to vote theron, to the extent of unreserved and unrestricted capital surplus available therefore.
>
> 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."[9]

Most statutes, like the Model Act, provide in substance, that a corporation's purchase of its own shares shall be limited to the extent of its surplus, except in special situations stipulated in the statute. In most states, including California, New York, and Delaware, purchases can be made to the extent of either type of surplus, earned or capital.[10] Furthermore, California,[11] New York,[12] and the Model Act[13] permit the use of surplus arising from a reduction of capital. The implications of this ability to make distributions to the extent of any kind of surplus--including that arising from the reduction of capital--will be considered below in the section dealing with the effective-

ness of the statutory provisions.

2. Insolvency.

A provision which in practice might be more restrictive than the "surplus rule" is that which prohibits purchases in case of existing or resulting insolvency. This provision exists expressly in the Model Act, and the California and New York statutes.[14]

The Model Act states simply:

> "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."[15]

The Act defines insolvent as "the ability of the corporation to pay its debts as they become due in the normal course of its business".[16]

It is conceivable that a corporation with unrestricted surplus might have its assets so committed as to be, or become, technically insolvent. Thus, this serves as an added restriction in that a corporation able to pass the "surplus rule" might still be unable to repurchase shares because of the solvency test.[17]

3. Exceptional cases.

Provisions generally exist for reacquisitions, for specific purposes, not subject to the rules governing impairment of capital, although these exceptions appear to be sub-

ject to the insolvency rule.[18] The Model Act provisions follow:

> "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."[19]

B. The effectiveness of corporation statute provisions.

(1) In practice, these statutory provisions do not serve as serious restrictions to treasury stock transactions. Most large publicly-held corporations have accumulated substantial amounts of earned surplus, and the surplus rule is, to that extent, inoperative. This is accentuated by the practice of American corporations of relying on undistributed earnings as a source of financing.

(2) Even within the restriction of the surplus rule, the statutes, with the exception of California, are effective only in restricting the net repurchase of shares at any one time, in that they

limit only the total amount of funds available; they are ineffective against a series of repurchases and reissues of shares.

The effect of the provisions of the Model Act can be shown as follows: Assume a corporation with the following balance sheet:

Assets	$1,000	Capital	$ 500
		Surplus-unrestricted	500
	$1,000		$1,000

If the corporation now reacquires shares by payment of $100, the statement would appear as:

Assets	$ 900	Capital		$ 500
		Surplus		
		-unrestricted	$ 400	
		-restricted	100	500
				$1,000
		less treasury shares		100
				$ 900

If the shares are reissued (for the same price), then the restriction on surplus is removed, and the statement would again show:

Assets	$1,000	Capital	$ 500
		Surplus	500
			$1,000

and the reacquisition and reissue could be started again, as part of a series of such transactions. While the maximum funds available would be $500, the acquisition and reissue of shares to that extent is unrestricted.

The California Corporation Code has a much more restrictive effect.[20] Under its provisions, treasury stock reacquired constitutes not a "restriction" of surplus, but a permanent reduction of surplus; the surplus is not reinstated when the shares are cancelled or reissued. If the shares are reissued, the proceeds must be considered as additional paid-up capital. Under the Code, the statement after the reacquisition, in the example used above, would appear as:

Assets	$900	Capital	$500
		Surplus (500 - 100 = 400)	400
			$900

When the shares are reissued, proceeds are credited to capital, and the statement would appear as:

Assets	$1,000	Capital	$ 600
		Surplus	400
			$1,000

This effectively reduces the surplus, and thus the funds available for the repurchase of shares. This is effective not only in terms of total net acquisitions, but also against a series of purchase-sale transactions.

(3) The statutory provisions are of limited effectiveness in protecting creditors and shareholders against distributions of funds by the corporation. This ineffectiveness has been recognized by capital suppliers and has given rise to the inclusion of restrictions on corporate distributions in the contractual arrangements made with credit-granting institutions or individuals. This phenomena has recently developed to such an extent that the principal restraint upon dividend distribution today appears to stem not from corporation statutes, but rather from such contractual restrictions.[21]

The general philosophy on which the statutory provisions are based is as follows:[22]

For the protection of creditors there is some minimum amount of the shareholders' investment in the corporation which must be maintained intact.[23] This minimum amount is not to be withdrawn by the shareholders or distributed by the corporation. Conceptually, the equity of the shareholders is divided into capital and surplus; the capital represents that portion of the equity which is to be maintained intact, with the remainder being surplus. A corporate distribution should not be allowed if the capital is already impaired or would thereby be impaired. In theory, this can be accomplished by allowing distributions only to the extent of surplus, and thus the development of the "surplus rule".

Legally, the shareholders' equity is divided into stated capital, capital surplus, and earned surplus. Stated capital conforms to the concept of capital outlined above, in that it is theoretically not subject to distribution. Stated capital, earned surplus, and capital surplus are subject to rigorous legal definition;[24] for purposes of this study, it is sufficient to define and use the term stated capital, (or simply capital), to mean that portion of the shareholder's equity which is legally not available for distribution to shareholders.

In practice, this structure of statutory provisions based on the stated capital approach can be so applied as to effectively negate the original intent of non-impairment of capital. Baker and Cary, in discussing the legality of distributions in general, state "Resourceful counsel should be able so to arrange any proposed transaction as to make the distribution legal, indeed air-tight, under existing acts."[25] The statutory provisions which restrict the funds available for distribution are rendered ineffective by the liberality of other sections of the statutes. In brief, this is how such a result occurs. In many cases, distributions may be made to the extent of capital surplus as well as earned surplus. Capital surplus can be created out of what would otherwise have been stated capital, thus effectively rendering stated capital available for distribution. Creation of capital surplus can be accomplished either by a formal reduc-

tion of capital or by crediting to capital surplus a part of the initial proceeds of the sale of shares. Thus, limiting distributions to "surplus" does not necessarily prevent impairment of capital. An analysis of these provisions follows.

(i) In many cases, distributions may be made to the extent of any kind of surplus,[26] capital as well as earned, and provisions exist for the creation of capital surplus out of what might otherwise have been stated capital.

(ii) Capital surplus may be created by formal reduction of stated capital. Then a distribution may be charged against this balance, or a deficit in respect to earned surplus written off against it, thereby freeing current and future earnings for distribution. The Model Act,[27] California,[28] and New York[29] permit the use of surplus arising out of a reduction of capital for repurchase of shares. The Model Act situation is particularly interesting in that it demonstrates the effect of provisions other than those directly relating to stock repurchase.

Section 5 states "...purchase of its own shares,... shall be made only to the extent of unreserved and unrestricted earned surplus available therefor,..." Up to this point, this is a simple "surplus rule" provision. However, this is weakened by the following clause: "...if the articles of incorporation so permit or with the affirmative vote of holders of at least two-thirds of all shares entitled to vote thereon,

to the extent of unreserved and unrestricted capital surplus available therefore." This clause demonstrates the real lack of effective creditor protection. Capital surplus is automatically available if articles permit it; if the articles do not, then a vote of the shareholders is sufficient to make it available. In either case, the creditor has no statutory protection. Kessler summarizes the practical effect of these provisions as follows:

> "Since it is customary for corporations to take advantage of permissive features of the corporation statutes, it is to be anticipated that all incorporations under these modern statutes will allow such purchases.
>
> It may be thus fairly stated that under the Model Act, and its progeny, almost any corporation may repurchase any of its shares out of any type of surplus, no matter how created."[30]

It is relatively easy for a modern corporation to reduce its stated capital, and provisions for easy reduction of stated capital are found in all the modern corporation statutes.[31] The Model Act, and the modern statutes influenced by it, are generous in allowing a reduction of stated capital in any case by two-thirds vote of the affected shareholders, or even by mere shareholder majority vote.[32] Thus, the creditor relying on the protection of the surplus rule may find the legal capital on which he relied being legally distributed to, and by, the shareholders.

(iii) Part of the proceeds of the initial issue of

shares to shareholders may be credited to capital surplus by action of the board of directors.[33] Thus the original capital investment may be distributed by purchase of shares or dividends. Since this allocation to surplus occurs at the time of initial issue, these funds never become part of stated capital, and the creditor does not, supposedly, rely on these assets for his protection. However, shareholders may find their original investment being distributed in the form of a dividend or by repurchase.

The practical effect of this provision is explicitly presented in this passage from the practice-oriented corporation law book by Henn.[34]

> "The desirability of creating capital surplus at the outset of corporate existence stems principally from restrictions which exist in many jurisdictions against using funds other than surplus for, or impairing capital, by means of dividends or expenditure of the corporation's funds, to purchase or redeem its own stock. In many such jurisdictions, capital surplus, as distinguished from capital, may be distributed as dividends or so expended. In such jurisdictions, the existence of capital surplus gives the corporation a flexibility it would not otherwise enjoy.
>
> Capital surplus can be created at the outset by issuing par value shares for more than par value (allocating the par value to capital and the excess or premium to capital surplus), and by allocating a part of the consideration received for shares without par value to capital surplus, with the balance allocated to capital."[35]

iv) The non-impairment of capital approach is rendered ineffective by yet another route directly related to stock reacquisition. This is accomplished by having reacquired shares serves as a reduction of stated capital, either automatically, or by motion of the board of directors. In Ohio, for example, stated capital may not be impaired, but repurchase of shares automatically effects a reduction of capital in the amount of the stated capital represented by the repurchased shares.[36] As long as the shares do not cost the corporation more than their stated value, a surplus will spring up after each reduction of capital, immediately available for purchase of more shares. Virtually the entire capital of a corporation may be exhausted in this way. The Illinois provisions also offer somewhat illusory protection.[37] The intent of the statute is obviously to limit repurchase distributions to earned surplus. However, a resolution of the board of directors will cancel the reacquired shares, and the cancellation reduces stated capital by the amount represented by the shares. Once again, virtually the entire capital of the corporation may be distributed by the directors, subject only to insolvency and certain filing requirements.[38]

(4) The insolvency provisions may be ineffective as a protective device as a result of the manner in which the state of insolvency is defined. The Model Act provides that 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.[39] This is interpreted as technical insolvency, rather than as bankruptcy, and refers to the ability to meet obligations as they come due, rather than the adequacy of total assets to cover total liabilities. Thus, the Model Act defines insolvent as "the inability of the corporation to pay its debts as they become due in the normal course of its business".[40] California prohibits repurchase when "...the corporation is unable,... or will be rendered unable, to satisfy its debts and liabilities when they fall due..."[41]

Accordingly, even this test allows shares to be repurchased where assets are not adequate to cover liabilities, since it is possible that a corporation might be able to meet its obligations for some time after the point of reaching insolvency in the bankruptcy sense, defined by the Courts as "an insufficiency of assets at a fair valuation to pay the debts".[42] Whether or not this would happen is a function of the structure of assets and liability maturity; if the assets are relatively liquid and debts fall due gradually, so that the real value of assets, (although not adequate to satisfy all liabilities), is adequate to meet the normally maturing liabilities for some period of time, this situation will continue to exist until the time of equity insolvency.

It is at this point that the creditor most needs protection, and will not receive it under the standard solvency test. It is precisely at this juncture that creditors deserve the assurance that the assets to be ultimately split by them will not be diluted by share repurchases.[43]

II - The legal and regulatory status of reacquired shares.

The Model Act defines treasury shares as follows:

> "'Treasury shares' means 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. Treasury shares shall be deemed to be 'issued' shares, but not 'outstanding' shares."[44]

Treasury shares are shares that have been issued; as such they remain issued, although not outstanding. As issued shares, they are part of both authorized and stated capital. Reduction of legal capital can be achieved only by methods specifically prescribed by statute. Only a few statutes include reacquisition of shares as such a method, and then only in exceptional circumstances.[45] Treasury shares must ultimately be dealt with in one of three ways. First, they may be cancelled, by due process, in accordance with charter and statute, in which case they revert to being authorized but unissued shares. Secondly, they may be held indefinitely, in the corporate "treasury" as treasury shares. Not considered outstanding, these shares do not enjoy certain

rights which apply to outstanding shares. The precise legal nature of treasury shares is subject to debate by the legal profession; courts have considered it as being[46] and not being an asset.[47] It is generally agreed, however, that for purposes of determining funds available for distribution as dividends or for the acquisition of treasury shares, it is not to be considered an asset.[48]

Treasury shares cannot be voted by the corporation, nor can they be included in determining the total number of shares outstanding.[49] A substantial number of jurisdictions forbid the voting "directly or indirectly" which bars the voting of shares held in the name of a nominee for the corporation or pledged by it or held by a subsidiary.[50]

Because treasury shares are not outstanding, dividends cannot be paid thereon.[51]

Thirdly, treasury shares may be reissued. Having once been issued and outstanding, these shares are free from certain limitations which normally apply to unissued shares. Treasury shares may be reissued for such consideration as may be fixed by the board of directors, without regard to par or stated value.[52] Unissued shares may generally not be issued for less than par value, although California does allow the sale of shares below par if they are not otherwise saleable.[53] It is generally agreed that the pre-emptive right does not apply on the reissue of treasury shares.[54] A corporation which desires to resell to the public shares which it has reacquired must register them under the Securities Act

of 1933, in the same way as a new issue of shares.[55]

III - The propriety of reacquisition.

A. The legal objectives of reacquisition.

For what purposes, and in what manner may a corporation exercise its right to reacquire shares? The corporation statutes provide a blanket right of reacquisition, in that nothing is said about the method to be used in reacquiring shares, or of the objective of stock reacquisitions. Normally, only in the case of the exceptions to the surplus rule are specific objectives considered.[56]

A reacquisition of shares is treated not as an extraordinary corporate transaction, but simply as an ordinary or normal business transaction.[57] Accordingly, the decision to reacquire shares generally does not require the approval of shareholders, but can be carried out on the initiative and authority of the board of directors alone.[58] The decision by the directors to reacquire shares is subject to the directors' fiduciary responsibilities to the corporation and the shareholder.[59] This fiduciary responsibility is generally considered to include due care, good faith and loyalty, and good business judgement.[60] The newly revised statutes generally agree that all directors must act in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.[61]

The following are generally considered to be legiti-

mate reasons for the reacquisition of shares by the corporation.[62] With the exception of those pertaining to the close corporation, the nature and mechanics of the various objectives will be considered in Chapter VII.

(1) To have shares available for reissue, in connection with stock-option, purchase or bonus plans; to be used as stock dividends; in connection with outstanding stock warrants and convertible securities; or to be used in mergers or other asset acquisitions.

(2) To effect a corporate distribution of equity funds to shareholders, as a partial liquidation, to recapitalize the corporation, to increase the leverage inherent in the capital structure.

(3) As an investment, short or long term, of idle funds.

(4) To buy out small shareholdings.

(5) Acceptance of shares in compromise of a debt.

(6) To eliminate fractional shares.

(7) Shares reacquired under terms of a stock-repurchase agreement.

(8) To settle a stockholder's derivative suit or pacify dissident shareholders.

(9) To facilitate the purchase of the corporation.

(10) To permit a large shareholder to eliminate its holdings in the corporation.

(11) To buy out dissenting shareholders at appraised values, when considering significant corporate changes.

(12) Limited purchases of shares for the purpose of stabilizing the market for a corporation's shares are legal, but repurchase for the purpose of supporting or manipulating the market price of shares is illegal.

(13) Share repurchases initiated by the directors or majority shareholders for the purpose of defending their control position. Such "defensive" repurchases appear to be legal if the directors can show that the action was taken in the exercise of their honest business judgement to eliminate a clear threat to the future of the corporation.

B. Rule 10b-5.[63]

The corporation which reacquires shares is subject to the provisions of federal securities legislation by virtue of being a purchaser of securities. The recent development of a "federal corporation law" via Rule 10b-5 is having a significant regulatory impact on the repurchase transaction. Also, the Securities and Exchange Commission has recently utilized its broad powers to exert control, both formal and informal, over corporations contemplating large-scale repurchase programs, and to deter insiders' participation in corporate

reacquisitions. These factors, combined with the decision of the Court in the Texas Gulf Sulphur case, indicate the rapid development in this area. While some issues are unsettled, an assessment of the present situation can be made with the aid of legal review articles and notes.

Rule 10b-5 is aimed at the prevention of fraud in the purchase and sale of securities. While the coverage of the rule is not limited to transactions by corporate insiders, it has been applied most frequently against officers, directors and controlling stockholders who deal in the corporation's stock without disclosing their superior information,[64] and it is in the application of the rule to purchase by corporate insiders that most of the special problems have arisen.[65] Past applications of the rule leave no doubt that corporate stock repurchases are within its scope,[66] since the repurchasing corporation possesses the ultimate in inside information. The typical pattern is a purchase offer by a corporate insider, (or the corporation itself) without disclosure of relevant financial data or other information which would indicate that the security is worth more than it would appear to be on the basis of the information available to the seller.[67]

This particular development of the Rule is indicated by the following description by the Court in a recent case:

> "The statute and rule basically call for fair play and abstention on the part of the corporate insider from taking unfair advantage of the uninformed outsider or minority stockholder. Such a stand-

> ard requires the insider to exercise reasonable and due diligence not only in ascertaining what is material as of the time of transaction, but in disclosing fully those material facts about which the outsider is presumably uninformed and which would in reasonable anticipation, affect his judgement."[68]

Incurrence of liability under the rule may result in sanctions being imposed against the issuing corporation on the initiative of the Commission or by individuals asserting private rights of action. The SEC has the power to conduct investigations, the authority to initiate actions for injunction, and the authority to recommend criminal proceedings by the Attorney General. The ability to initiate injunctions allows the Commission to force a corporation to stop a transaction that appears fraudulent, rather than rely exclusively on criminal prosecution after the deed. The Commission has not been hesitant to initiate actions or to use the threat of investigations or injunction to enforce its views.[69] Furthermore, private parties may bring suit to enforce this liability even though neither section 10b nor rule 10b-5 mentions private enforcement.[70] Thus, the corporation can be sued by private individuals for any damages resulting from fraud within the meaning of Rule 10b-5.

All repurchase transactions are subject to the provisions of the rule. Liability under Rule 10b-5 can arise from transactions between sellers face to face with buyers, from transactions carried out on a stock exchange,[71] and from transactions not on a stock exchange.[72]

C. Materiality.

The essential problem for the repurchasing corporation is the adequate disclosure of material information in connection with a repurchase program. The duty of disclosure may be breached by omissions to disclose facts as well as by affirmative misrepresentations.[73] Resolving the question of materiality is the crucial factor in avoiding liability. The Courts have not strictly defined materiality, but some guidelines do exist. As a bare minimum, the corporation should fully disclose its current earnings and the approximate market value per share of its assets.[74] Unusual information which has a material bearing on the securities value, such as the anticipated sale of assets, should be disclosed.[75] As a rule, insiders have been required to reveal any important event, discovery or business trend not generally known to the investing public which would directly influence the market value of the stock or the judgement of an average prudent investor. Increased dividends, higher earnings, and new acquisitions are typical examples.[76] One author has suggested that to be safe, in a tender offer, to include as much information as in a prospectus.[77]

However, the Courts have been reluctant to require disclosure of those corporate plans which were no more than possibilities.[78] Information of a purely speculative nature need not be divulged, and may even provide a basis for a claim of misrepresentation if disclosed.[79] Non-disclosure of material facts will not be excused on the grounds that publication

of pending matters -- merger negotiations or a new and untested product -- would adversely affect their eventual outcome.

The Court took the position that:

> "If...disclosure prior to effecting a repurchase or sale would be improper or unrealistic under the circumstances, then the proper alternative is to forego the transaction."[80]

One writer sums up the effect of the Court's position as follows:

> "Yet the SEC in Cady, Roberts & Co. stated bluntly that if material facts could not be revealed, the insider had no business in the market."[81]

The Court, in the recent Texas Gulf Sulphur decision, addressed itself to the question of materiality, and it appears that a less inclusive definition of materiality has resulted. The Commission, in its submission to the Court, embraced the standard of materiality that includes those facts "which in reasonable and objective contemplation <u>might</u> affect the value of the corporation's stock or securities."[82] The Court, taking a stricter interpretation of materiality, said that material information is "information which, if known, would <u>clearly</u> affect investment judgement"[83] or which "<u>directly</u> bears on the intrinsic value of a company's stock."[84] (Emphasis mine.) The Court further stated that "managements' duty of disclosure under rule 10b-5 should be limited to those which are <u>reasonably certain</u> to have a <u>substantial effect</u> on

the market price of a security if disclosed."[85] (Emphasis mine.) One author felt that this had introduced a more stringent definition of materiality, and had made the disclosure requirements less onerous.[86] Ruder, however, felt that the definition was not important, since regardless of definition, the Court could be expected to exercise judicial discretion in applying that definition to get what it considered just results.[87] The Wall Street Journal interpreted this rejection by the Court as the failure of "the SEC's attempt to establish a broad definition of what is material ..."[88] Certainly it is safe to say that this interpretation was no more onerous than previous interpretations.

Directly related to reacquisition, Manuael Cohen, Chairman of the SEC, has strongly supported proposed legislation which would establish specific disclosure requirements for the corporation intending to repurchase its shares, the "reverse prospectus" requirements.[89] (These provisions are part of a larger bill which deals mainly with the regulation of cash tender offers made for the purpose of acquiring control of publicly-held corporations, a topic not applicable to this present study.) In general, it is suggested by Cohen that the corporation be required to provide information relating to the reasons for the purchase, the source of funds to be used, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and "such additional information as the Commission deems necessary or

appropriate in the public interest..."[90] This would ostensibly have to be done before the reacquisition is carried out. Whether or not the bill becomes law, it is clear that the Commissioner is of the opinion that the present apparatus, including Rule 10b-5, is not adequate. Equally interesting, Chairman Cohen said that, while the Commission would welcome the specific statutory authority which the bill would give, the Commission already has several rules which apply in this area, and that he believed that the Commission had additional rule-making power under the existing statutes. He implied that this additional power, as yet not exercised, would be adequate to achieve the recommended effects.[91] It would appear reasonable to expect the Commission to attempt more rigorous enforcement of disclosure in regard to stock reacquisition transactions.[92]

Two issues of materiality are peculiar to corporate repurchases; whether the corporation must reveal the reasons for which it is purchasing its own stock, and whether, in the case of open-market acquisitions, it must disclose its identity as a buyer.[93] Loss states that there has been no case decision on the question of whether failure to disclose the indsider's identity is itself a violation of the rule.[94] Loss,[95] as does the unidentified author of a recent note on repurchase,[96] feels that this question must be viewed in relation to materiality, and that the reason for repurchase and the purchaser's identity must be considered together. At the

present time, when the corporation buys on the open market it need provide no public explanation of its motives.[97] It would seem that the fact that the corporation itself is purchasing is significant information to the shareholder. The corporation's reason for repurchase would always be material to the shareholder; there would be no doubt about materiality where the purpose was something as major as a merger, acquisition, or contraction, and if it were a more routine reason, such as a stock option plan, then it is significant to the shareholder that none of the other, less routine, reasons apply. There would seem to be no circumstance under which a shareholder would not interpret the corporation's repurchasing as implying that management feels the shares are a "good buy" at that price. It would appear also that there is no legally valid reason that the shareholder should not be aware of the corporation's identity; any protest that disclosure of the corporation's identity would be harmful to the corporation seem to be invalidated by the Court's pronouncement in the Cady, Roberts case.[98] Concealing its identity with a fraudulent intent, -- "with the intention of preventing the seller from acquiring information which might reasonably have proved a factor influencing the other party to refrain from entering into a contract" -- would definitely be illegal.[99]

Loss, in summary, states:

> "In short, all that can be safely said in the present state of the law is that an insider cannot be certain that failure to disclose his identity will not be con-

> sidered a violation of Rule 10b-5, or at the very least will not be more likely to lead to the courts to find a violation when the non-disclosure of identity is considered in connection with all the other circumstances."[100]

It would appear not unreasonable to believe that disclosure of either or both of these facts would be considered as required, should this question appear before the Courts in the future.

D. Disclosure.

Apart from the question as to what is material, there is the question of what constitutes adequacy of disclosure. Since liability under Rule 10b-5 applies to transactions conducted on national securities exchanges and the over-the-counter market as well as face-to-face transactions, other methods than personal notification must be relied on. Disclosure is not adequate simply because the information is contained in corporate documents which, by law, the shareholder could find available to him.[101] Furthermore, the corporation is not able to rely on the disclosure of information in its required reports to the SEC.[102] It is probably safe to assume that direct communication to each shareholder individually is adequate disclosure.

The Court, in the Texas Gulf Sulphur case, indicated by implication that release of material information to news media constitutes full disclosure. However, the Court rejected the argument that the news was public even before the

press conference, by such means as rumors printed in New York newspapers and a glowing article in a Canadian mining publication.[103]

Ruder, in an article which considers the Texas Gulf Sulphur case directly, makes the following recommendation concerning disclosure:

> "It is important that the company use all effective means to inform the public of significant corporate developments. Disclosure to a small group of professional investors or to one reporter will probably not satisfy the disclosure requirement. The media to whom important information should be disclosed might include the following:
>
> (1) the Dow-Jones financial news service
> (2) the Associated Press and United Press International
> (3) Moddy's and Standard and Poor's
> (4) a commercial wire service
> (5) local newspapers
> (6) brokerage houses."[104]

E. The SEC and market price manipulation.

The Commission has evidenced concern with the opportunities for market price manipulation offered by large-scale repurchase programs. In order to reduce the effect of such programs on market price, the Commission has suggested that these corporations limit their open-market purchases to 10% of the monthly trading volume in their stock.[105] The Commission has also used its investigatory power -- coupled with the implied right of a civil action -- to deter insiders' participation in corporate reacquisitions.[106] This may effect-

ively remove the temptation on the part of insiders to use a repurchase program to drive up the shares' market price and then sell their shares to the corporation at this higher price.

Recently concluded proceedings by the Commission against two corporations may serve as effective guidelines to corporations planning large-scale repurchases.[107] Both corporations had been buying shares, and at the same time issuing shares for acquisitions -- thus buying during a distribution. Both corporations eventually agreed to abide by the Commission's provisions, which were substantially similar, (though not identical) in the two cases. The aims of the provisions are two: to guard against price manipulation, and to protect the tendering shareholder against fraud on the part of the purchasing corporation. The substance of the provisions is as follows:[108]

Daily and weekly repurchases on the open-market may not exceed a specified percentage of the average daily and weekly volume of trading in the corporation's shares. Only one broker may be employed each day; no bid may be placed or purchase made at a price in excess of the last sale price or highest contemporaneous bid; and trading at the daily opening of the Exchange is either prohibited or severely restricted. Furthermore, conditions were laid down which can be viewed as guidelines for all listed companies planning concurrent share repurchase and acquisition of other companies.[109] At the

commencement of any "serious negotiations" looking toward a merger involving the re-issue of its stock, the repurchasing corporation must furnish the other parties with complete information respecting the daily volume and price range of repurchases during the previous thirty days. When definite terms of an acquisition have been agreed upon, all repurchases must be discontinued:

(1) until the acquisition has been approved, if necessary, by the stockholders of the acquired company;
(2) if the exchange must be registered under the 1933 Act, until the exchange offer is terminated; and,
(3) until the number of shares to be distributed in the exchange has been fixed by binding contract.

It would seem not unreasonable to assume that all corporations carrying on a major repurchase program, for whatever purpose, might find themselves held to similar buying restriction by the Commission.

F. Reporting requirements.

Under the Securities Exchange Act,[110] a listed corporation is required to file a report at the end of any month during which a decrease by more than 5% of the amount of securities of a class previously outstanding.[111] The listing agreement of the New York Stock Exchange[112] includes the following:[113]

a) Reporting within ten days after the close of a fiscal quarter of any reacquisition or disposition of stock for the account of the company.

b) Prompt notification of all facts relating to the purchase of any of the corporation's listed securities at a price in excess of the market price prevailing on the Exchange at the time of purchase.

c) Prompt notification of any corporate action resulting in redemption, cancellation or retirement of any part of its listed securities.

IV - Summary.

The most important legal and regulatory aspects of treasury stock transactions can now be summarized. Corporations in every state are empowered to reacquire their own shares, and the "surplus rule" limitations are generally not considered to be restrictive in practice.

A most important fact is that the stock reacquisition transaction is legally an ordinary, (rather than extraordinary), transaction of the corporation. This means that the transaction can be carried out on the initiative and authority of the directors, without the approval of the shareholders. The shareholders need not be notified that the

transaction will take place, or even that it has taken place. Furthermore, there are no statutory requirements concerning the price to be paid for the shares, the method of reacquisition, the selection of shares to be repurchased, or the purpose for which shares are reacquired.[114] All of these decisions fall to the directors who have a fiduciary responsibility to act in good faith and in the best interests of the shareholder.

A corporation is an "insider" and is subject to the provisions of Rule 10b-5 when it repurchases its shares. As a result, the corporation must make adequate disclosure of material information concerning its acitivities. The corporation when repurchasing must also be careful not to have a manipulative effect on the market price of its shares, contrary to the provisions of the Securities Exchange Act. The requirements of disclosure, materiality and non-manipulative repurchase practices are currently not fully clear, but the Commission has evidenced a strong interest in the problems connected with this area.

Treasury shares cannot be voted or counted in determining sufficient vote, can be reissued as would previously unissued shares, and on reissue are subject to the same registration requirements as previously unissued shares. Treasury shares can be issued at a discount while new shares may not,[115] and the pre-emptive right does not apply on the issue of treasury shares while it may on the issue of new shares.

With the exception of these two aspects, there is no legal difference between the issue of treasury shares and of new shares. The corporation issuing treasury shares does so, legally, exactly as if it were issuing new shares, and shareholders receiving treasury shares are subject to the same rights and limitations as if they were new shares.

Footnotes

1. Specifically, the Securities Act of 1933 and the Securities Exchange Act of 1934. Concerning the development of a federal corporation law, see the comment of the Commission in the Cady, Roberts case (Securities Exchange Act of 1934, Release No. 6668, November 8, 1961) and also the comment of Court in McClure v Borne Chemical Co. Inc., 292 F. 2d 824, 834 (C.A. 3, 1961).

   See also: Arthur Fleischer, Jr., "Federal Corporation Law: An Assessment", Harvard Law Review, LXXVIII, pp. 1146-1179.

2. The past decade or so has witnessed rather complete revisions in Alabama, Alaska, Colorado, Connecticut, D.C., Florida, Iowa, Maryland, Massachusetts, Mississippi, Nebraska, New York, North Carolina, North Dakota, Oregon, South Carolina, Texas, Utah, Virginia, Wisconsin, and Wyoming. See: Robert S. Stevens and Harry Henn, Statutes, Cases and Materials on the Law of Corporations and Other Business Enterprises (2nd edition, St. Paul, Minn.: West Publishing Co., 1965), p. 19.

3. Model Business Corporation Act. The Model Business Corporation's Act is the product of the Committee on Corporate Laws (Section of Corporation, Banking and Business Law of the American Bar Association) and the American Bar Foundation. The Model Business Corporation's Act - Annotated is a three volume work which presents the provisions of the Model Act and compares them with the corresponding actual provisions in the general business corporation statutes of the fifty-two American jurisdictions. The first complete version of the Act was published in 1953, and has been revised in 1955, 1957, and 1959, with the last complete revision published in 1960 with all statutes reflected as at January 1960. Pocket supplements have been published to bring the

statutes and annotations up-to-date to 1966, both for the Model Act itself, and for the actual state statutes. Accordingly, the Model Act will be used (and cited) not only as a source of the Model Act provisions themselves, but also as an authoritative source of information on parallel provisions in state statutes.

4. Baker & Cary, p. 10.

5. Stevens and Henn, p. 19.

6. Kessler states: "Since the Model Act is the archetype of modern corporation law provisions on the subject, its potential dangers warrant analysis in order that states proposing to enact similar provisions may at least legislate with complete cognizance of the social implications involved." Fordham Law Review, XXVIII, p. 644.

   The latest edition of the Financial Handbook also recognizes this influence:

   "The Model Business Corporation Act of the American Bar Association has had a great influence on the statutory law as to corporations. This has resulted in the adoption by many states of new business corporation laws, based in large part on the Model Business Corporation Act, which modernizes previous corporation laws." Jules I. Bogen (ed.), Financial Handbook (4th edition, New York: The Ronald Press, 1964), pp. 12, 18.

7. Model Act, Sec. 5, paragraph 2a., p. 186, Vol. I. It is interesting to contrast, without belaboring the point, the change in the nature of the power to reacquire shares. At the present time, this power is expressly stated in the statutes, rather than being implied. Kessler, writing as recently as 1959, said:

   "Of the fifty-two American jurisdictions (the fifty states plus the District of Columbia and Puerto Rico), all but ten grant express statutory authorization for the exercise of the power, and even in the corporation laws of most of the latter, the existence of the privilege is made clear enough. Further, the absence of express authorization is no indication of a lack of corporation power." p. 638.

8. Alabama, Alaska, Colorado, Connecticut, Iowa, Kentucky, Missouri, North Dakota, the District of Columbia, Mississippi, Nebraska, Texas, South Carolina, South Dakota, Utah, Washington and Wyoming have enacted provisions identical to, or similar to, that of the Model Act. Model Act, Vol. I, p. 186, and supplement, p. 74.

9. Model Act, Sec. 5.

10. Model Act. Vol. I, p. 186.

11. Ibid., California Corporation Code, Sec. 1707(b).

12. Kessler, Fordham Law Review, XXVIII, p. 638.

13. By providing that any surplus arising out of a reduction of capital is capital surplus. Model Act, Vol. I, p. 187.

14. Kessler notes that such a provision exists in all modern statutes, p. 643, n. 19.

15. Model Act, Sec. 5.

16. Model Act, Sec. 2(n).

17. But see discussion below in this chapter concerning the effectiveness of these provisions.

18. Harry G. Henn, Handbook of the Law of Corporations and Other Business Enterprises (St. Paul, Minn.: West Publishing Co., 1961), p. 522, interprets insolvency as "often an additional general limitation". The Model Act, Sec. 5, was reworded in the 1956 version to make the insolvency prohibition applicable in all cases, a change from the 1953 version, which supports Henn's position.

19. Model Act, Sec. 5.

20. California Corporations Code, Sec. 1704, 1705-1708 and 1904-09. See also Moonitz and Jordan, pp. 192-201.

21. "As a practical matter, during the period of post-war prosperity (i.e., 1946 to date - 1957), it may be said that the modern law of dividends has been developing by these contractual (rather than statutory) restrictions. In nearly all business concerns, there is an earned surplus on the balance sheet, but the question remains whether by contract it has been frozen and is thus no longer available." Baker & Cary, p. 947. This discussion concerns distributions in general, rather than only dividends. Baker & Cary point out that to be effective the restriction against dividends must include share repurchase.

22. This discussion is intentionally brief and conceptual, and the author recognizes that it is currently held that statutory provisions regarding capital and surplus are no

longer purely creditor-oriented, but are aimed also at protecting the rights of shareholders. However, this conceptual approach is adequate to demonstrate the nature of the ineffectiveness of statutory provisions, the sole purpose here. See generally Wilber G. Katz, "The Philosophy of Midcentury Corporation Statutes", Law and Contemporary Problems, XXIII (1958), pp. 178-192. Also see Ray Garrett, "Capital and Surplus Under the New Corporation Statutes", Law and Contemporary Problems, XXIII, No. 2 (Spring, 1958), pp. 239-263.

23. "Even if the concept of capital as a 'trust fund' for the creditors of a corporation be rejected, it is well established that one of the basic reasons behind the capital requirement is to provide for sufficient corporate assets to discharge corporate obligations." Henry W. Ballantine, Corporations (Rev. edition, Chicago: Callahan & Company, 1946), pp. 571-572.

24. The Model Act definitions, and interpretive comment on the "trust fund doctrine" by Garett and Kessler, and on the Model Act provisions by Garett, are presented in Appendix III.

25. Baker & Cary, p. 948.

26. Including the Model Act, California, New York and Delaware. Model Act, Vol. I, p. 186. Of the modern corporation statutes, only the District of Columbia, while allowing the four extraordinary Model Act purchases from capital, confines all other purchases to earned surplus. "Thus, with but one exception, modern corporation statutes permit utilization of any surplus for share repurchases, provided formalities are complied with." Kessler, Fordham Law Review, XXVIII, p. 661, n. 82.

27. By providing that surplus arising out of a reduction of capital is capital surplus. Model Act, Sec. 64.

28. California Corp. Code, Sec. 1707(b).

29. Kessler, Fordham Law Review, XXVIII, p. 638.

30. Ibid., p. 662.

31. Ibid., p. 663, n. 89.

32. Where the new stated capital is not below the sum of the aggregate par value of all shares plus the combined liquidation preference of all shares having such rights. Model Act, Sec. 63.

33. Except for preference shares for which an amount equal to any liquidation preference must be allocated to stated capital, the Model Act would now permit allocation of any portion of the consideration received for no par shares to capital surplus. Model Act, Sec. 19. For discussion of the various statutory treatments of the proceeds of issue as to stated capital or surplus, in respect to both par and no-par shares, see Baker & Cary, pp. 799-809.

34. Henn. It is worth noting that according to the preface, this book is intended to be of aid to the practicing lawyer as well as to prepare students for corporate and related practice. p. XII.

35. Ibid., p. 326.

36. "Rule 10b-5 and Purchase by a Corporation of its Own Shares", Northwestern University Law Review, LXI, No. 2 (May-June, 1966), pp. 312-313.

37. Ibid.

38. Ibid.

39. Model Act, Sec. 5.

40. Model Act, Sec. 2(n).

41. California Code, Sec. 1708.

42. Finn v. Meighan, 325 U.S. 300, 303 (1945).

43. Nemmers, "The Power of a Corporation to Purchase its Own Stock", Wisconsin Law Review, XVII (1942), pp. 161-170. Demonstrates that a corporation may be a going concern under the equity insolvency test and still bankrupt, and the judicially approved use of its waning assets at this critical time to bail out shareholders by stock repurchases.

44. The Model Act, Sec. 2(n).

45. Baker & Cary, p. 1052.

46. 244 Iowa at 824, 56 vw 2d at 194, pl.

47. Borg v International Silver Co., 11R. 2d 147 (2d Cir 1935).

48. Harry Kottler, "Treasury Stock: A Corporate Anomaly," Cleveland Marshall Law Review, I and II (1951-53), p. 12.

49. Model Act, Sec. 31(2).

50. "Treasury shares are nowhere permitted to be voted,... A substantial number of jurisdictions forbid the voting of shares held in the name of a nominee for the corporation or pledged by it or held by a subsidiary." The Model Act, II, p. 502. See also: Calif. Code Sec. 1714.

51. Model Act, Vol. I, p. 28.

52. Model Act, Sec. 17. Baker & Cary, p. 797.

53. California Code, Sec. 1110.

54. Kottler, Cleveland Marshall Law Review, I and II (1951-53), p. 12. Also: Treasury Stock, 36 Yale Law Journal, 1118 (1927).

55. F.T.C. Release No. 131, March 13, 1943.

56. With the exception of North Carolina -- which statute provides that, with the exception of transactions which fall into the "exceptions" category, shares must be purchased only pro rata, or on an organized stock exchange, or upon the approval of the holders of a majority of the share exclusive of those held by the selling shareholder, or in connection with regulated stabilizing operations. Latty refers to this as "A novel attempt to foreclose favoritism in the repurchase of a corporation's own shares..."Elvin R. Latty, "Some Miscellaneous Novelties in the New Corporation Statutes", Law and Contemporary Problems, XXIII, n. 2 (Spring 1958), p. 380.

57. Extraordinary matters normally includes mergers, dissolutions, reorganization, change of capital structure, amendments to the articles of incorporation, and sales of corporate assets other than in the regular course of business. Henn, p. 279.

58. The Model Act, New York, and Delaware require shareholder approval only for the purchase of shares out of capital surplus, and then only in certain cases; otherwise, the directors are fully empowered to initiate and carry out the reacquisition of shares. However, Louisiana, Ohio, and South Dakota require shareholder consent in substantially all cases. Model Act, Vol. I, p. 187.

59. The theory of "social responsibility" which would require that directors have a fiduciary responsibility to employees, customers and the general public as well as to shareholders

and creditors, does not seem to have much practical effective support. "While this theory has been much discussed by philosophers of corporation law, it has almost no reflection in the actual statutes." Katz, Law and Contemporary Problems, XXIII (1958), pp. 178-192. Folk points out that of the few recent statute revisions which codify the director's general duty, they vary either in not naming the beneficiary of the duty or in stating that the duty runs only "to the corporation," or "to the corporation and its shareholders". Ernest L. Folk, III, "Corporation Statutes: 1959-1966," Duke Law Journal, VI, No. 4 (Autumn 1966), p. 892.

60. See generally, Baker & Cary, pp. 393-598.

61. Folk, Duke Law Journal, VI, No. 4 (Autumn 1966), p. 888.

62. This survey of legitimate purposes of stock reacquisition is drawn from various sources, where supporting cases are cited and discussed. See especially "Corporate Stock Repurchases under the Federal Securities Laws", Columbia Law Review, LXVI , No. 7 (November 1966), pp. 1292-1301; "Rule 10b-5 and Purchase by a Corporation of its own Shares", Northwestern University Law Review, LXI, No. 2 (May-June 1966), pp. 307-328; "The Regulation of Corporate Tender Offers Under Federal Securities Law: A New Challenge for Rule 10b-5," The University of Chicago Law Review, XXXIII , No. 2 (Winter 1966), pp. 359-386; Zilber, University of Cincinatti Law Review, XXXIII , pp. 315-380; Kessler, Fordham Law Review, XXVIII (1959-1960), pp. 637-688.

63. 17 C.F.R. 240-10b-5 (1964). Rule 10b-5 was promulgated by the Securities and Exchange Commission pursuant to authority granted by Sec. 10 of the Securities Exchange Act of 1934; Section 10 provides the following:

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

...to use or employ, in connection with the purchase or sale of any security registered on a national exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The Rule is virtually identical to Sec. 17(a) of the 1933 Act, except that that section applies only to sellers of securities; Rule 10b-5 was passed in 1942 to effectively extend Sec. 17(a) to purchases as well as sales of securities. Louis Loss, Securities Regulation (Temporary Student Edition; Boston: Little, Brown and Company, 1961), 1427. (Hereinafter cited as Loss.)

Rule 10b-5 provides:

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

1) to employ any device, scheme, or artifice to defraud;
2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or,
3) to engage in any act, practice, or course of business which operates...as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

64. Columbia Law Review, LXVI, No. 7, p. 304.

65. Loss, p. 1445.

66. Loss, p. 1453, University of Chicago Law Review, XXXIII, p. 360.

67. Loss, p. 1446.

68. Kohler v. Kohler Co., 319F. 2d 634, 642 (7th Ar. 1963).

69. David S. Ruder, "Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur", Northwestern University Law Review, LXI, No. 6 (January-February 1967), pp. 874-906, p. 877, n. 21.

70. Loss, p. 1763, University of Chicago Law Review, XXXIII, p. 362.

71. Loss, p. 1454.

72. University of Chicago Law Review, XXXIII, p. 362.

73. Ibid.

74. Ibid.

75. University of Chicago Law Review, XXXIII, p. 365.

76. Columbia Law Review, LXVI, p. 1304.

77. Zilber, University of Cincinatti Law Review, XXXIII, p. 336. Forerunner of the "reverse prospectus"?

78. Columbia Law Review, LXVI, p. 1304.

79. University of Chicago Law Review, XXXIII, p. 367.

80. Cady, Roberts & Co.

81. University of Chicago Law Review, XXXIII, p. 369.

82. SEC Pre-trial memorandum of Law (Texas Gulf Sulphur case), p. 18. Value included market as well as intrinsic value.

83. SEC Texas Gulf Sulphur Co., 258F Supp 262, 277 (SDNY 1966) at 208.

84. Ibid.

85. Ibid.

86. "Securities Regulation," San Diego Law Review, IV (January 1967), p. 22.

87. Ruder, Northwestern University Law Review, LXVI, p. 886.

88. Wall Street Journal, August 22, 1966, p. 4.

89. Manuel F. Cohen, "A Note on Takeover Bids and Corporate Purchases of Stock", The Business Lawyer, XXII, No. 1 (November 1966). Actually, Chairman Cohen was discussing S. 2731 and HR 14416, introduced into the 89th Congress, 1st session, on which hearings were never held. A new bill, S. 510, was introduced, in modified form, which was passed by the Senate on August 30, 1967 and on which hearings were held. That bill was generally consistent with the position of the SEC, as indicated by Cohen.

90. Bill S. 510, reported in 113 Cong. Rec. S. 445 (daily ed., January 18, 1967).

91. Cohen, p. 156. But see Manne, (who questions whether in fact this is the case), p. 252, and Brudney, Victor, "A Note on Chilling Tender Solicitations", Rutgers Law Review, XXI, No. 4 (Summer 1967), pp. 609-644; Manne, Henry, G., "Cash Tender Offers for Shares -- A

Reply to Chairman Cohen", Duke Law Journal (Vol. 1967), No. 2 (April 1967), pp. 231-253.

The dispute between Cohen, who supports the Bill, and Manne and Brudney, centers not on the regulation of reacquisition, but on cash take-over bids, by outsiders, via the tender offer, which is not relevant here, since the shares are not being repurchased by the corporation itself.

92. The Commission's interest in disclosure is further evidenced by the appointment of the study group on that topic. Securities Act Release No. 4885, November 29, 1967.

93. In tender or direct negotiation, the identity is, by nature, automatically revealed.

94. Loss, p. 1463.

95. Ibid., pp. 1464-65.

96. Columbia Law Review, LXVI, p. 1305.

97. Ibid., p. 1307.

98. See notes 80 and 81, this chapter, above.

99. Loss, p. 1464.

100. Ibid., p. 1465.

101. University of Chicago Law Review, XXXIII, p. 366.

102. Ibid.

103. Wall Street Journal, August 22, 1966, p. 4.

104. Ruder, Northwestern University Law Review, LXI, p. 803.

105. Fortune, November 1965, pp. 245-246.

106. See the discussion, in Chapter VII, of the Wolfson - SEC interplay in connection with the Merritt-Chapman tender offer in 1964.

107. SEC v Georgia-Pacific Corp. CCH Fed. Sec. L. Rep. para. 91692 (SDNT May 24, 1966). Genesco, Inc. CCH Fed. Sec. L. Rep. para. 77354 (SEC 1966).

108. Cohen, The Business Lawyer, XXII, No. 1, pp. 155-156; Columbia Law Review, LXVI, p. 1299

109. Columbia Law Review, LXVI, p. 1300.

110. Rule 13a-11, 17CFR, 240.13a-11 (1949).

111. Form 8-K, Item 8.

112. The American Stock Exchange Listing Agreement has a similar provision, American Stock Exchange Listing Form 1, Sec. 1, Para. 8-11 (1962).

113. Other NYSE provisions relating to the manner of execution of a tender offer are discussed in Chapter VI. NYSE Listing Agreement, Sec. 1, para. 8-11 (1959).

114. With the exception of North Carolina; see note 56 above, this chapter.

115. Except California; see note 53 above, this chapter.

CHAPTER V

The federal income tax aspects of stock reacquisition.

I - The corporation.

Treasury stock transactions do not create income for the corporation. The Internal Revenue Code does not recognize gain or loss as resulting from a repurchase by a corporation of its own shares, or from the reissue of treasury shares by a corporation for either money or property.[1] However, if a corporation accumulates earnings for the purpose of acquiring its own shares, the acquisition may amount to a distribution of dividends disguised as a purchase of shares. If the accumulated earnings were paid out as dividends, the shareholder would have to pay income tax on the full amount at the ordinary rate. By distributing the same funds as a purchase of its shares, the shareholder is liable for tax only on the amount of the capital gain and possibly at the more favorable capital gains rate. If it is found that a corporation is accumulating earnings to acquire its shares so as to enable its shareholders to avoid income tax, the corporation may become liable for an accumulated earnings tax. The matter is discussed further in the chapter.

The reporting requirements of the Code may affect the attractiveness of the various methods of reacquisition. When a corporation engages in a tender offer, it must file an information return with the IRS within 30 days of the adoption of the

plan.[2] If a corporation distributes $600 or more to a shareholder, it must file an information return that includes the name and address of, the number of shares owned by, and the amount paid to each shareholder.[3] This requirement applies to any reacquisition from a shareholder, whether by tender or direct purchase. It does not apply to repurchases by the corporation in the open-market, because that does not qualify as a redemption. A redemption is defined as a distribution of assets to a shareholder.[4] A purchase made in the open-market is not considered to be a transaction with a shareholder. Since the identity of the selling shareholder is not normally known in an open-market transaction, this could not be reported. Similarly, in every case in which a shareholder transfers stock of a corporation to that corporation for a consideration, the facts and circumstances must be reported by the shareholder on his tax return.[5] A sale of shares in the open-market need not be reported as such by the shareholder (although it must be reported in the determination of tax payable on the gain/loss on the transaction).

II - The selling shareholder.

The general scheme of the relevant income tax provisions is presented before beginning the examination of specific provisions of the Code. Such an examination is necessary to understand the effect of the income tax provisions on the choice of method of reacquisition. It will serve also to provide an

insight into the spirit of the provisions which govern the tax-treatment of corporate distributions in the hands of shareholders. This insight is necessary for the examination of tax-avoidance as an objective of reacquisition in Chapter VII.

The tax provisions recognize a repurchase of shares as a distribution by the corporation to the selling shareholder. The tax treatment of such a distribution by the recipient shareholders depends on whether it is treated as an ordinary dividend or a sale of shares. If treated as a dividend, then the full amount of the distribution is taxable at ordinary income tax rates.[6] If not treated as a dividend, then only the amount of the gain on sale is taxable, and that may be eligible for the lower capital-gains rate.

Every distribution is automatically taxable as a dividend unless it qualifies as "not being in the nature of a dividend". A repurchase qualifies as not being a dividend if

i) it is a partial liquidation of the corporation, or

ii) it is "substantially disproportionate".

The technical provisions will now be considered.

A. Partial liquidation.

A repurchase of shares will be treated as a sale, (and therefore not as an ordinary dividend), if it qualifies as a distribution in partial liquidation of the corporation.[7] To achieve this status, it must be a distribution which:

(a) is not essentially equivalent to a dividend,

(b) is a redemption of a part of the stock of the corporation pursuant to a plan, and

(c) occurs within the taxable year in which the plan is adopted or within the succeeding year.[8]

To qualify under this test, the repurchase must be a planned distribution of assets generated (made available) by a deliberate decision to discontinue conducting a trade or business after the distribution. Technically, this test will be satisfied by a distribution which meets the requirements of Section 346(b).[9] Because of the restrictiveness of the terms, few stock reacquisitions qualify for favorable tax treatment under this section. This provision applies only to situations where a corporation stops operating one part of its total business, and, within a short time, distributes the assets thereby made available. It is essential that the assets must become available directly as a result of this cessation.[10] A distribution of funds generated by operations, obtained from loans or a liquidation of an investment portfolio, does not qualify.[11] Furthermore, an investment in stock, securities, land or other properties, no matter how substantial, does not satisfy the requirement of Section 346(b) as to being "a trade or business".[12]

B. "Substantially disproportionate".

If a repurchase of stock does not qualify as a partial

liquidation, it may still qualify for favorable tax treatment under one of the tests of Section 302(b). This section is designed to determine whether any real change in the proportionate interest of individual shareholders has occurred. If no such change has occurred, then the distribution is equivalent to a dividend. The test is applied to the circumstance of each individual shareholder, rather than to the corporation, as is the partial liquidation test. This point, and the specifics of Sec. 302(b), are important to the shareholder who is trying to arrange his sale of shares to the corporation so as to qualify for favorable tax treatment. As will be seen below, these provisions may affect the shareholder's response to the corporation's repurchase, and therefore the corporation's choice of method.

The three relevant[13] tests of Section 302(b) are:

1. Termination of interest.[14]

If a shareholder sells all his shares to the corporation, then the distribution is eligible for favorable capital gains treatment. If he sells less than all of his shares, the shareholder must look to the other two tests.[15]

2. Substantially disproportionate redemption.[16]

The essential requirements of this test are two: (a) the shareholder must own less than 50% of the voting stock after the reacquisition, and (b) his holding of shares as a percentage of total shares outstanding must be less than 80% of the same percentage before the reacquisition. Accordingly,

even a small shareholder, (who at no time held 50% of the shares outstanding) would have to reduce his proportionate position by at least 20% to qualify under this section.[17]

3. Dividend non-equivalence.[18]

Under this provision, a repurchase will be eligible for capital-gains treatment if it is not "essentially equivalent" to a dividend. The burden of proof is on the shareholder, and the Regulation states that whether a repurchase satisfies this test depends on the facts and circumstances of each case.[19] For example, a pro rata repurchase will be considered a dividend. No other concrete criteria are available in respect to a publicly-held corporation, because all cases previously decided pertained to repurchases in a close-corporation situation.[20]

4. Constructive ownership.

The "constructive ownership" rules are an integral part of the application of Sec. 302(b) in determining the potential tax treatment of a repurchase. These provisions may be significant in the case of a major shareholder in a publicly-held corporation.[21] By virtue of these rules, a taxpayer is "considered as owning any stock" that is:

(a) owned by certain members of his family;

(b) owned by partnerships, estates, certain trusts and certain corporations in which he is interested; or,

(c) subject to an option held by him, and conversely, entities in which he is beneficially interested may be treated as owning

stock owned by him.[22]

The selling shareholder must take these into account when contemplating the sale of shares to the corporation and intending to look to any of the provisions of Sec. 302(b) to qualify for favorable tax treatment.

III - The effect of the income tax provisions on the reacquisition transaction.

Under the present provisions, the use of the open-market method of reacquisition ensures that the distribution will be eligible for capital gains treatment in the hands of the shareholder. A repurchase of shares in the open-market is not considered a redemption under the provisions of the Code, and the proceeds of sale in the hands of the shareholder are not considered to be a dividend. None of the provisions discussed above apply to such cases, and the shareholder naturally deals with this as an ordinary sale of shares. Administratively, the Internal Revenue Service has no way of treating this as a taxable distribution, since no reports are required on the part of either the corporation or the shareholder which could associate the repurchase and the sale.

With the use of a tender-offer or a direct-purchase, the tax treatment must be determined on the basis of the facts applicable to the case. If the distribution can qualify as a liquidating dividend, it does so on the basis of corporate, rather than shareholder, circumstances, and the proceeds will

be eligible for capital gains treatment in the hands of all shareholders. The three tests under Sec. 302(b), however, are applied to each shareholder individually. Each shareholder must study his own case to determine the tax status of a sale to the corporation, and in a given repurchase, the proceeds may be taxed as a dividend for one shareholder, and as a capital gain for another. A proportional reacquisition would always be taxed as a dividend, by virtue of any of the three parts of Sec. 302(b).

In a direct purchase, the selling shareholder should be able to determine the number of shares to sell to qualify as a sale, even if he does not terminate his interest. In a tender offer this is difficult, if not impossible, since the shareholder may not be certain of either the total number of shares to be repurchased or of the number of his own shares which will be purchased.[23] The shareholder controls only the number of shares he tenders, not the number he sells or the total number repurchased.

The fact that a distribution may be eligible for capital-gains taxation may be of varying significance to shareholders. If a repurchase would otherwise qualify for treatment as a sale, the lower capital gains rate is still not applicable unless the shares have been held for at least six months. Accordingly, a shareholder might not respond to a tender offer simply because the shares had not been held by him for six months.

Given the applicability of the capital gains rate, the effect of this rate differs between individual and institutional shareholders. Corporations are granted an 85% "dividends received deduction" on dividend income. If the marginal tax rate on income is assumed to be 50%, then the effective rate on dividends is 50% of the taxable 15%, or 7.5% of the total dividend. If the proceeds qualify as other than a dividend, then this 85% deduction is lost.[24] Accordingly, institutional investors cannot be expected to view repurchase arrangements as favorably as individual investors.

In summary, a distribution to shareholders can be rendered eligible for favorable capital gains treatment by the properly-planned use of stock reacquisition. A repurchase will be eligible for capital gains treatment if it is carried out in the open-market, or if it qualifies as a partial liquidation for income-tax purposes. A repurchase may so qualify for an individual shareholder if he arranges his affairs so as to meet the test of Sec. 302(b). A pro rata repurchase never qualifies for capital gains treatment.

Footnotes

1. Internal Revenue Code Sec. 1032-a, and Treas. Reg. 1-1032-1(a).

2. Code Sec. 6043 and Treas. Reg. 1.6043-1. This section is also applicable to redemptions under Sec. 302, by virtue of Sec. 346(a).

3. Code Sec. 6043(2), Treas. Reg. 1.6043-2(a). The secretary of the IRS may also require that any amount less than $600 also be reported.

4. Code Sec. 317.

5. Treas. Reg. 1.1302-2(b).

6. But only to the extent of "earnings and profits", which need not correspond to the amount of corporate retained earnings or earned surplus. See discussion below in Chapter VII.

7. Code Sec. 331(a)(2). Section 301, (the dividend section), is specifically inapplicable to partial liquidation by virtue of Code Sec. 331(b).

8. Code Sec. 346(a)(2). Only one of the two definitions of partial liquidation is relevant here, see 346(a)(2). The other, Sec. 346(a)(1), stipulates a distribution which is one of a series of distributions in redemption of <u>all</u> the stock of a corporation <u>pursuant to a plan</u>, and is not relevant here, since this study is concerned only with ongoing corporations that reacquire some part of their shares other than as an integral part of a scheme of deliberate and complete corporate liquidation.

9. The requirements of Section 346(b) are four-fold:

   (a) The distribution must be attributable to the corporations ceasing to conduct, or must consist of the assets of, a trade or business;

   (b) Immediately after the distribution, the distributing corporation must be actively engaged in a trade or business;

   (c) Both the retained trade or business and the one that was distributed (or that gave rise to the distribution) must have been actively conducted (though not necessarily by the distributing corporation) throughout the five-year period preceding the distribution;

   (d) Neither trade or business may have been acquired by the distributing corporation within the preceding five years in a transaction in which gain or loss was recognized in whole or in part.

10. Treas. Regs. 1.346-1(c), 1,344-1(c), 1.355-1(d). Zilber states, "The major problem in deciding whether section 346(b) is satisfied is in the determination of what is the active conduct of a trade or business." p. 354. The Regulations

define it as a "specific existing group of activities being carried on for the purpose of earning income or profit," and "it must include every operation which forms a part of or a step in, the process of earning income or profit from such group."

11. Regs. 1.346-1(c), 1.355-1(c) and (d).

12. Ibid.

13. Sec. 302(b)(4) relating to the repurchase of stock issued by railroad corporations in reorganizations is not dealt with here.

14. Code Sec. 302(b)(3).

15. A shareholder may tender all his shares to qualify, but find that not all of the shares are purchased, thus defeating his intent. Zilber feels, with some reservation, that the shareholder could qualify by selling the remaining shares in the open market. p. 359.

16. Code Sec. 302(b)(2). This test has three provisions, all of which must be met to qualify the repurchase for capital-gains treatment in the hands of the shareholders.

    (a) Immediately after the redemption the shareholder must own less than fifty per cent of the total combined voting power of all classes of stock entitled to vote.

    (b) Immediately after the redemption the shareholder's percentage of total outstanding voting stock must be less than eighty per cent of his percentage of voting stock immediately prior to the redemption.

    (c) Immediately after the redemption the shareholder's percentage of the total income stock (voting or non-voting), must be less than eighty per cent of his percentage of common stock immediately before the redemption.

17. This would entail selling more than 20% of his holding, since the total shares outstanding has also been reduced. To make the calculation of the appropriate number of shares to sell would require definite knowledge of the total number of shares to be repurchased.

18. Code Sec. 302(b)(1).

19. Treas. Reg. 1.302-2(b).

20. Zilber, University of Cincinatti Law Review, XXXIII, p. 340.

21. The rules are set out in Sec. 318, and made applicable to Sec. 302(b) by Sec. 318 and Reg's. 1.302-1(a) and 1.302-2(b).

22. Boris I. Bittker and James S. Eustace, "Federal Income Taxation of Corporations and Shareholders", (2nd edition, Hamden, Connecticut, 1966). For a technical discussion of the attribution rules, see pp. 280-284.

23. Tender offers often leave "open" the total number of shares to be purchased, and normally do not guarantee the purchase of all shares. In the case of an "over-tender" the corporation may make actual purchases pro rata to the amounts tendered, and may reserve the right to adjust the total number to be purchased. See the discussion of the methods of reacquisition below in Chapter VI.

24. It would be incorrect to compare the 7.5% with the 25% capital gains tax, because the latter applies not to the full amount, but only to the gain on disposal.

CHAPTER VI

The Potential Implications of the Reacquisition Transaction.

The implications of stock reacquisition are a function of many factors, all or most of which can be usefully related to either the objective or the method of reacquisition. In this chapter, the conceptual implications of a stock reacquisition per se -- the act of reacquiring, without regard to the objective of the transaction -- are examined. Because the implications of a given reacquisition may be a function of the manner in which the transaction is carried out, the methods of reacquisition are also examined. In Chapter VII, repurchase transactions are categorized by reference to the objective of reacquisition and the objectives considered one by one.

I - The potential implications of reacquisition.

The word 'potential' is used here in the sense that these implications might conceivably occur in connection with any given reacquisition; whether they actually occur in any specific case is a function of the circumstances. It will be seen that in some cases, the implications of reacquisition constitute the objective of reacquisition, while in others, they are an unintended, perhaps even unrecognized, effect.

The implications of reacquisition for the shareholder

arise from the effect on the shareholders' interest in the corporation. The extent and value of a shareholder's interest is a function of the value of the corporation, the total number of shares outstanding, and the number of shares held by him. Because reacquisition causes a decrease in the assets of the corporation as well as a reduction in the total number of shares outstanding, every shareholder is subject to the effects of a reacquisition whether or not he is party to the transaction.

A distinction must be made between repurchase transactions, which involve the corporation, and ordinary share transactions, which do not. (An ordinary share transaction, as used here, is one in which the corporation is neither the buyer nor the seller of shares -- the usual transaction between investors dealing in outstanding shares.) The implications for shareholders of these two transactions are significantly different. While the ordinary transaction affects only the selling shareholder and the buyer, the repurchase transaction has an effect on the value of the corporation, and therefore on all shareholders. Because the repurchase has an effect on the value of the corporation, a shareholder can gain or lose as a result of such a transaction without being party to it, or even being aware of it. In an ordinary transaction, only the buyer and seller can gain or lose, and a loss can be avoided by avoiding the transaction. The shareholder of a repurchasing corporation can refuse to sell shares

to the corporation and still be unable to avoid a loss.

This distinction between the repurchase transaction and the ordinary share transaction is a most significant one. Because all shareholders of a repurchasing corporation are subject to the effects of repurchase, it is possible that this transaction should be regulated to a different extent or in a different manner than the ordinary share transaction. To a considerable degree, the ordinary transaction is regulated on the basis of "let the buyer beware", coupled with an attempt to ensure that the buyer is reasonably well informed. This approach is not necessarily appropriate in connection with the repurchase transaction; what of the seller -- the company's own shareholders -- and those shareholders who do not sell? This question -- pursued further in Chapter VII -- is introduced here because it is fundamental to the consideration of the public regulation of the reacquisition transaction.

There are two distinct types of implications arising from a stock reacquisition. The first is that of inequity between shareholders as a result of the direct effect on the value of the shareholder's interest in the corporation. The second is the implication arising from the impact on voting position.

A. Inequity among shareholders.

Potential inequity among shareholders of the reacquiring corporation is the most significant problem concern-

ing reacquisition. The common shareholder has a residual interest in the corporation, which consists of his proportionate share in the total corporation, as measured by the percentage of total common shares outstanding which he owns. It follows that the value of that interest is equal to his proportionate share in the total value of the corporation, whatever that value may be, and however difficult it may be to measure. Normally, when a shareholder considers selling his shares -- to someone other than the corporation -- he will do so only if the price offered is at least equal to the value of his interest in the corporation. He will not sell if he feels that the proceeds are inadequate by this measure, and he is able to avoid the loss by not selling his shares.

The case of the shareholder considering whether to sell his shares to the corporation is significantly different. The shareholder may enjoy a gain or suffer a loss as a result of not selling his shares as well as by selling them.

This statement does <u>not</u> refer to the opportunity cost of having foregone the opportunity to sell profitably; rather, it refers to increase/decrease in the value of his interest as a result of the corporate reacquisition, in which he himself did not participate.

In general, whether or not he sells, his gain or loss as a result of the corporation's reacquisition is a function of the price paid for the shares. If the price is greater than the value of the shares, then the value of the remaining shares

will decrease; if the price paid is less, then the value of the remaining shares will increase.

Obviously, a reacquisition will be beneficial to an individual shareholder if he sells to the corporation for a price greater than the value of his shares, and detrimental if he sells to the corporation for a price less than the value of the shares. Less than obvious, but also true, a reacquisition will be beneficial to a shareholder when the corporation buys the shares of <u>other</u> shareholders at a price less than their value, and will be detrimental when it buys the shares of other shareholders at a price greater than their value.

The effect of a reacquisition on a shareholder is a function of the following variables:

i) The repurchase price per share;

ii) The fraction of the total shares outstanding repurchased by the corporation; and,

iii) The fraction of his shares which the shareholder sells.

This effect can be measured by the change in the value of the shareholders' interest in the corporation as a result of the reacquisition. The value of the shareholders' interest before the reacquisition is equal to the value of the shares held; after the reacquisition, it is equal to the value of the shares retained plus the proceeds of disposal of the

shares sold.

In any given reacquisition, the actual effect is a function of two relationships:

i) the relationship between the price paid for the shares and the value of the shares before reacquisition, and

ii) the relationship between the fraction of total shares outstanding and the fraction of his shares sold by the shareholder.

There is no change in the value of the shareholders' interest if the price paid per share is equal to the value of the share, or if the percentage of his shares sold by the shareholder is equal to the percentage of total shares outstanding purchased by the corporation. The latter is the case of proportional reacquisition. What if neither of these conditions exists -- the price does not equal the value of the shares, and the reacquisition is not proportional? In that case, the effect on the value of the shareholders' interest will be a function of the relationship between the variables indicated above. Appendix IV contains a simple mathematical formula which demonstrates the effect of the relevant variables under various circumstances. Also included are tables showing the effect of reacquisition on the basis of assumed values for the variables. While the formula and tables are not included here, they are useful in demonstrating certain points. With the aid of the formula, the effect of

reacquisition under various combinations of variables can be demonstrated -- i.e., price greater than value and the shareholder selling more/less than the proportional share of his holdings. Also, the use of the formula makes explicit the fact that the value of the corporation's shares may be changed directly as a result of repurchase transaction, but not as a result of an ordinary share transaction. Probably most significant, study of the formula and tables creates an awareness that the only variable normally under the shareholder's control is the number of shares that he will sell, and that his decision on this matter must be made on the basis of his assessment of the relationship between share price and share value.

As demonstrated in Appendix IV, the significance, to the individual shareholder facing a proposed reacquisition, of the relationship between the key variables can be summarized as follows:

(a) If the price to be paid is greater than the value of the shares, the shareholder can avoid any decrease in the value of his interest by selling a fraction of his shares equal to the fraction of total shares repurchased. He will benefit by selling more than that fraction and will maximize his position by selling all of his shares.

Most significant, to simply protect his interest, the shareholder must sell the proportionate share of his holding. The more shares he sells, the better.

(b) If the price to be paid is less than the value of the shares, then the shareholder will enjoy a benefit if he sells less than the proportionate share of his holdings, and his gain will be maximized by selling none of his shares. If he sells his proportionate share, he will neither benefit nor suffer a detrimental effect. If he sells more, he will suffer, and the detriment will be greatest if he sells 100 per cent of his shares. The fewer shares he sells, the better.

(c) If the price is equal to the value of the shares, the shareholder will not enjoy a benefit or suffer a detriment regardless of the percentage of shares reacquired by the corporation. Faced with this situation, the shareholder would be indifferent as to whether he sells any portion of his shares.

(d) At any price -- equal to, above or below the value of the shares -- there will be no effect on the shareholder's position if he sells that percentage of his holding which is exactly equal to the percentage of outstanding shares reacquired by the corporation. If he sells more or less than that percentage he will gain or lose, to an extent which is a function of the price.

It follows that, in any reacquisition[1] where the price is not equal to the value of the shares before reacquisition, unless each shareholder sells a fraction of his shares equal to the fraction of total shares outstanding repurchased, some shareholders will benefit from the reacquisition, and at the

expense of the other shareholders. Alternately, in any reacquisition of shares which is not proportional to each shareholder, unless the price is equal to the original value of the shares, some shareholders will benefit, and at the expense of other shareholders.

Accordingly, to enable the individual shareholder to protect his interest, the following conditions would have to apply:

(1) The price to be paid for the shares must be equal to the value of the shares. If this does not apply, then,

(2) The shareholder must have the opportunity to sell or retain such shares as he deems desirable in the light of his assessment of the relationship between the share's value and the price paid. Furthermore, the shareholder would require the information necessary to allow him to make that assessment correctly.

Before relating these conditions to the practical methods of reacquisition, the implications of the impact on voting control position will be explored.

B. Voting position.

The second implication of a stock reacquisition is the effect on the voting position of individual shareholders or groups of shareholders. Since treasury shares cannot be

voted, a repurchase reduces the number of shares eligible to vote. This increases the proportion of total voting shares represented by a given holding of outstanding shares. In any given reacquisition, the voting position of an individual shareholder may be affected whether or not he sells any part of his shares. If a shareholder sells none of his shares in a repurchase program, his proportion of voting shares will always increase. If he sells some part of his shares, the change in his voting position will depend on the fraction of the total shares outstanding reacquired by the corporation as well as the fraction of his own shares which he sells. If the fraction of his original holding which he sells is identical to the fraction of outstanding shares reacquired, then his voting position will be unchanged. If the fraction he sells is smaller than the fraction repurchased, his voting position will be improved; if larger, his position will be impaired.[2] It follows that any reacquisition which is not proportional to all shareholders will cause a change in the voting position of some or all shareholders.

Two distinct practical situations are relevant. The first is where the reacquired shares are to be retained by the corporation, and the second is where the shares are to be reissued. It will be seen in Chapter VII that many of the objectives of reacquisition explicitly include the reissue of treasury shares, while other objectives are attained by the act of reacquisition itself, with the subsequent retention of

the shares by the corporation.

When the shares are to be retained, the shareholder can always improve his position by not selling any of his shares, and can maintain it by selling the proportionate fraction of his shares. Therefore, he can protect his voting interest, given the opportunity to sell such part of those shares he deems necessary and the information required to calculate the appropriate fraction of his shares to sell. Unless he has this opportunity, he might, by not selling any shares, find his voting position improved, even to the point of being in a control position where previously he was not. Alternatively, if he had been in control and had sold too many shares, he might find that his control position has disappeared, with the help of his own selling activity.

A shareholder could lose effective control even though he sold only the proportionate fraction of his shares so as to maintain his percentage voting position. In those cases where this percentage voting position is less than 50 per cent, the shareholder might act to maintain the percentage, but another shareholder might refrain from selling, thereby bringing his own percentage voting position up high enough -- larger than the original control position -- to take over control. For example, assume a corporation with 100 shares outstanding, and shareholdings as follows:

A - 40 shares - 40% of voting shares, effective control.

B - 30 shares - 30% of voting shares.

All others - 30 shares - 30% of voting shares.

If the corporation reacquires 30% of outstanding shares, or 30 shares, and A restricts his selling to 30% of his holding so as to protect his 40% position, but B sells none of his shares, this will be the result:

	Original Holding	Sells	Resulting Holding	Resulting %
A	40	12	28	40.0
B	30	0	30	42.8
All others	30	18	12	17.1
Total reacquired		30		99.9
Total shares outstanding - after			70	

Accordingly, it may not be adequate for a shareholder to be able to sell the proportionate fraction of his holdings; he may require the knowledge to be able to sell less than this amount of shares to protect himself against the occurrence demonstrated. He would be protected if all shareholders were to sell the proportionate fraction of their holdings, but in lieu of this he would require knowledge of other shareholders' plans and the opportunity to sell such shares as are appropriate.

The minority shareholder may find that the effective voting control of the corporation has changed hands by virtue of the reacquisition. A former minority shareholder now controls the corporation, control having been shifted from the original controlling shareholder, somewhat as demonstrated

above. Even though the shareholder is unable to keep control from changing hands, he may want to take the opportunity to increase his own voting position, or to maintain it. Alternately, since the minority position might now be less attracive given the new controlling interest, he might want to decrease his holding in the corporation. In such cases, the opportunity to sell shares or to retain them is required, but also a knowledge of what other shareholders will be doing.

It should be noted that the opportunity to refrain from selling, to be effective, includes the knowledge on the part of the shareholder that the corporation is buying. The shareholder may have decided to sell X number of shares in the market, without knowledge of the corporation's reacquisition intent. However, the significance of selling X shares becomes greater, in terms of the percent of voting shares disposed of, when the corporation reacquires shares thereby reducing the total number of shares outstanding. Although the shareholder had decided to sell previously, he might <u>now</u> not wish to sell -- to make this decision, he must have knowledge of the reacquisition.

If the reacquired shares are to be reissued, the number of shares outstanding will in due course return to the pre-reacquisition number. In that case, the shareholder's voting position will have been weakened to an extent which is a function of the number of shares which he sold. The informa-

tion that the shares will be reissued is vital for the protection of the shareholder's original voting position; to maintain his position, he must now sell none of his shares. The shares may be reissued to the general public, thereby reaching a large number of shareholders, or the shares may be issued in a block to one shareholder, possibly creating a controlling or a major interest. Alternately, the shares may be issued to shareholders who already hold an effective controlling interest, but who wish to strengthen their control position. If the change in control is undesirable, or if the increase in the dominance of the major shareholder is unwelcome, then this information is required to allow the shareholder to sell all or part of his holding. In such cases, the shareholder must be informed that an acquisition is occurring, and that the shares are to be reissued.

Accordingly, in order to enable the individual shareholder to protect his interest with respect to voting position, the following would have to apply:

1. The individual shareholder must have the opportunity to sell such shares as he determines appropriate in the circumstances.
2. The individual must have available such information as will allow him to decide whether to sell or retain his shares, including:
   (a) the corporation's intent to repurchase, and the number of shares to be repurchased;

(b) whether or not the shares will be reissued, and, so far as it can be determined in advance, to whom;

(c) the intentions of other shareholders to sell their own shares.

II - The methods of reacquisition.

The essential aspects by which the methods of reacquisition differ are:

1. the manner of arriving at the price paid for the shares;
2. the effective opportunity afforded to all shareholders to participate in the sale of shares to the corporation;
3. the extent of disclosure to all shareholders of the corporation's intent to reacquire shares; and,
4. the extent of disclosure, to all shareholders, of information pertinent to the corporation's decision to reacquire, including the number of shares to be repurchased and the reason for repurchase.

A. Open market purchase.

The methods of reacquisition are generally classified as open-market, public tender offer, and (direct) private purchase.

The repurchase of shares in the open market is the simplest method of reacquisition, and the most significant in terms of both the number of times used as well as the number of shares reacquired.[3] The corporation simply approaches the

market, as would any other buyer, and purchases the shares at the market price.[4] The price is determined in the market, without negotiation between buyer and seller.[5] Since buyer and seller remain unidentified in the market, the corporation has no control over whose shares will be purchased and all shareholders are offered an opportunity to participate in the sale of shares to the corporation. Since the purchase is at the market price,[6] the shareholders can sell at that price to some buyer, if not to the corporation.

There is currently no legal or regulatory requirement that the corporation disclose to the public or communicate to the shareholders its intent to repurchase its shares in the open market, and since the buyer is unidentified in the open market, there is no necessary communication to the shareholder of the corporation's intent to repurchase.

In practice, corporations have traditionally made little effort to disclose to the shareholders either the intent to repurchase or the fact that they are actively repurchasing.[7] Regulations of the S.E.C. and N.Y.S.E. require notification of repurchase in the open market only after the fact, if at all,[8] and even then neither requires disclosure of the price paid for the shares. As indicated above, the corporation is required to make such disclosure as is necessary to avoid liability for fraud against the selling shareholder. In practice, corporations have generally made little disclosure specifically because of the reacquisition program.[9]

In fact, Young, on the basis of his interviews, cites this lack of disclosure as both an inherent characteristic of the method, and one of the advantages of its use. "On open-market purchases, the prevention of information leaks is essential to the success of the operation. If secrecy is not maintained, the price can be bid up to a point at which the completion of the operation will be unfeasible."[10] In discussing the advantages of the relative methods, "Two advantages of the open-market purchase...are that it can usually be carried on in secrecy..." The authors of a recent article instructing management as to the disclosure that must be made to avoid liability for non-disclosure, have a heading entitled "Generally recommended publicity practice -- all companies."[11] In discussing the transaction "Treasury stock -- increase or decrease," their instruction under that heading is "normally no publicity". As a result, in connection with open-market repurchase, information of considerable potential significance may be undisclosed, including the corporation's intent to repurchase, the reason for repurchase, the number of shares intended to be purchased and actually purchased, the price to be paid and actually paid.

B. <u>The tender offer</u>.

Although the open-market method is the simplest, there is a trend toward the use of the public tender offer by reacquiring corporations. One reason may be the more complete

disclosure involved with the tender offer, a reason cited by Guthart.[12]

However, from the corporation's point of view, the relevant factor is probably the size of the repurchase rather than the matter of disclosure. Even in connection with an open-market purchase, complete disclosure could be accomplished simply by direct-mail communication with shareholders, a simpler procedure than a tender offer. Where a relatively large number of shares is needed, a tender offer may be the only way that sufficient shares can be acquired without unduly pushing up the market price and the total cost to the corporation. If the shares were simply purchased in the market, the price might be driven up substantially, whereas sufficient shares will normally be attracted by offering a price not materially above the market price at the time of the tender offer.[13] Ryder System, Inc., in October 1965 offered to buy 300,000 or more of its common shares at $18 per share, when the stock had closed the previous trading day at $15.75. A spokesman said the Company had been buying its shares on the open-market, but that not enough were available to get the number needed.[14] United Fruit felt it could acquire only one thousand shares a day, or a maximum of 260,000 shares in a year, by open-market transactions, and thus they had to go to a tender offer.[15]

A tender offer is a formal communication by the corporation to its shareholders, inviting them to offer all

or part of their holdings to the corporation in accordance with the terms specified in the tender offer itself.[16] This offer is normally communicated directly to shareholders by letter, published in the financial press, and released through the financial reporting services. The offer normally stipulates a maximum number of shares to be purchased, or a maximum amount of funds to be spent. Hilton Hotels Corp. offered to purchase 300,000 shares,[17] United Fruit Co. limited the price the company will pay to $26 a share, and indicated a maximum total expenditure of $10 million.[18]

A specific price may be set by the corporation, or a maximum price set, with the shareholders asked to tender their shares at a price of their own choosing. Thus, Hilton Hotels set the maximum at $29.50, and United Fruit at $26, while Ryder Systems offered a flat $18 per share, as did Texam Oil Corp.,[19] who set a price of $2.50 per share. In both the Hilton Hotels and United Fruit offers, the price was set by the shareholder. The specific or maximum price to be paid is not less than the market price, since no shares would be tendered at such a price. The price will be higher than the market price to ensure the tendering of the reacquired number of shares.[20] Thus, the maximum or stated price, and the market price, ( ), for Hilton Hotels $29.50 (28.50), United Fruit Co. $26.00 (24.625) and Ryder Systems $18.00 (15.75). If a relatively large number of shares are reacquired, a significant premium may be necessary. Curtiss-Wright in

setting a firm tender price, chose $32.00, when the market price was $27.00 -- a premium of approximately 18%.[21] They were, however, requesting tender of 1 million shares out of approximately 7.5 million shares outstanding, or over 13% of outstanding shares. Likewise, Mangood Corp., in offering to purchase 60% of its outstanding shares, offered $50 per share.[22] This was a premium of $10.75 per share above the market price, of $39.25, a premium of approximately 25%. The size of the premium may also depend on the purpose for which shares are being reacquired.[23]

All shareholders are offered an opportunity to sell their shares, but may refuse to do so if the price is considered inadequate. Tishman Realty and Construction Co. offered to buy a maximum of 500,000 shares, but were tendered only 391,886 shares, although the price was set above the market. As the company bought the shares, the market price kept rising until it exceeded the tender price.[24] Similarly, Merritt-Chapman and Scott sought 1 million shares, but were tendered only 141,607 shares.[25]

The offer is announced in advance of the official tender date to allow adequate time for shareholders to become informed and to evaluate the offer.[26] There is often provision for the corporation to extend the time limit on the offer.[27] Provision is made in the offer for the selection of shares to be purchased if more than the maximum number of shares are tendered. If the price is set in the offer, then

the shares are usually purchased pro rata to the number tendered; if the shares are to be purchased at the lowest price offered, then this selection problem is automatically solved. Curtiss-Wright said that if more than 1 million shares are tendered, it reserved the right to purchase all, part or none of the shares above 1 million. If fewer than the total number of shares tendered are purchased, the purchases would be pro-rated among tendering shareholders.[28] American Cement said it would purchase all shares tendered up to 450,000 and reserved the right to buy additional shares if tendered.[29]

A somewhat novel approach to price setting and share selection was used by Universal Leaf Tobacco Co. in calling for tenders of its stock.[30] The company directors voted to buy up to about $3 million of shares, but allowed shareholders to name their price. The company reserved the right to reject all offers which exceeded a maximum price -- yet unestablished. When the price was to be established, however, all shares tendered at a price <u>below</u> that price would be paid <u>that</u> price.

The selection process may also be affected by the purpose of reacquisition. Texam Oil Corp. made an offer to buy all the outstanding common stock from shareholders who own 10 or fewer shares.[31] The purpose was to reduce the number of shareholders, thereby specifically selecting those

shares to be purchased. Hilton Hotels Corp. required specifically 300,000 shares and stated that if the number of shares offered was below 300,000, the officers and directors would offer a maximum of 10% of their shares.

The reacquisition of shares by a public tender offer involves the disclosure of the corporation's intent to reacquire shares, and the offer is normally communicated directly to the shareholders. The time between the announcement of the offer and the deadline for tendering allows dissemination of information and an assessment of the situation by shareholders. There is usually fuller disclosure of the facts surrounding the corporation's intent to reacquire. The very fact that the corporation intends to repurchase indicates to the shareholder that the corporation considers the shares a "good value" at the indicated price. It is usual, although not without exception, for the corporation to disclose the reason for repurchase in the offer. The reason given may be vague, but the corporation must be careful not to make a misleading statement, since a positive statement <u>is</u> being made. American Cement, in its announcement of the offer, said the shares would be used for acquisitions and mergers, "as suitable opportunities arise, although the shares will be available for other corporate purposes".[32] Zapata Off-Shore Co. said in material sent to shareholders that the purpose of the reacquisition was to increase earnings per share of common stock remaining outstanding.[33] Tishman Realty and Construction

Co. did not say why the shares were being repurchased, but did say that the shares purchased would all be retired, which rules out many of the usual objectives of reacquisition.[34] On the other hand, Curtiss-Wright and Williams-McWilliams Industries Inc.[35] gave no reason for the reacquisition.

For those corporations listed on the New York Stock Exchange, the tender offer is subject to certain requirements of that body.[36] The Exchange requires a minimum period of ten days for the tender offer to be open, although thirty days is suggested. Airmail notice and provision for telegraphic acceptance is urged when the minimum period of ten days is used. Where the company is accepting only a specific number of shares, tenders are to be accepted on a pro rata basis for at least ten days, after which acceptance on a "first-come, first-served basis" is permissible. Furthermore, the corporation is required to give immediate publicity to the offer -- a general news release promptly after the corporation's decision to seek tenders to one or more newspapers of general circulation in New York City, to one or more of the national wire services, and to the Dow-Jones news ticker service.[37]

C. Private purchase.

The reacquisition of shares by private purchase directly from the selling shareholder involves direct contact between buyer and seller, with the price being determined by

negotiation. This includes shares deliberately purchased from a shareholder, or group of shareholders, whether the shareholders be individuals or institutions. In practice, it would also include the acquisition of shares in settlement of a debt, and shares repurchased from terminated employees. The price to be paid for the shares is established by negotiation between buyer and seller, and may be higher than the market price if an inducement to sell is necessary. Alternately, if the shares constitute a relatively large holding, and the seller wishes to sell, the price may be somewhat below the market. The potential difficulty of selling the large holding without depressing the share prices may render the seller willing to accept a price somewhat less than the market.

The directors, in setting the price to be paid for shares, may legally set a price above market value, but are restricted by the fact that they may be held responsible to show that they acted in good faith and in the best interests of the corporation. There is no legal requirement that the price paid for the shares be disclosed, and it normally is not disclosed. Singer Co., in disclosing a purchase of 200,000 shares of its common stock in a negotiated purchase from an institutional holder, did not disclose the price paid per share.[38] Merritt-Chapman and Scott, in a letter to shareholders in connection with a tender offer, said that the company bought shares in 1962 and 1963, some in private pur-

chases at prices above the market.[39] While the prices were admitted to be above the market, the actual price was not given.

Whatever the price, the opportunity to sell shares to the corporation is not available to the other shareholders.[40] The corporation's intent to reacquire shares is disclosed to the shareholder(s) with whom negotiations are carried out, but not necessarily to other shareholders. Such disclosure as is made of the affairs of the corporation is normally made only to the potentially selling shareholder, but not to all shareholders. Accordingly, the intent to repurchase, the number of shares to be repurchased, the price paid and the reason for repurchase may remain undisclosed to all shareholders except those involved in the transaction. Furthermore, even those shareholders involved may not be told the corporation's reason for repurchase, or the maximum price which the corporation would be willing to pay.

D. The methods of reacquisition in practise.

The characteristics of the various methods are summarized in Table 3.

The peculiar characteristics of the individual methods of reacquisition make them suitable to the reacquisition of shares for specific purposes. The open-market method is best used for purchase of relatively small numbers of shares, although it may be carried on for a considerable

TABLE 3.

Summary of the characteristics of the methods of reacquisition.

	Tender Offer	Open Market	Direct Purchase
(1) manner of determination of price	Price at or above the market, in accordance with published offer by company, offer made by shareholders.	Price at the market, price determined in the market place.	Price set by negotiation, will not be much below the market.
(2) opportunity for all shareholders to sell	Yes	Yes	No
(3) disclosure to all shareholders of intent to purchase, or of identity as purchaser	Normally full disclosure	No necessary disclosure of intent, or identity, normally no disclosure.	No necessary disclosure, normally only after, if at all.
(4) extent of disclosure to all shareholders of pertinent information	Relatively full disclosure.	Minimal disclosure.	No necessary disclosure to those not selling.

time, or even continuously. With this method, the company need not decide whose shares it will acquire or what price it will pay. The method is not appropriate for purchasing a relatively large number of shares in a short time, for purchases at too high a rate may drive up the market price. Not only will this make the shares expensive, but it may also be illegal under the anti-manipulation provisions of the Securities Act.

Where a relatively large number of shares is required, or where it is necessary to purchase specific shares, then the tender-offer or direct purchase are applicable. If a large number of shares is required, and if the holder of such shares is willing to sell or can be induced via price to sell, the direct purchase is indicated. If such a known supply does not exist, then the tender-offer is used. The tender-offer is expensive not only because of the premium over market price that must be paid, but because of the legal costs and paper-work involved. The tender-offer may be slower than the direct purchase because of planning, the time between announcement and deadline, and the time for delivery of shares. Where shares are needed quickly, the direct purchase is potentially best, if it can be arranged.

Certain objectives of reacquisition require the selection of shares to be purchased -- this can be achieved with the direct purchase, and to some extent, with the tender-offer.[41] Open-market purchase is totally unselective, while

the direct purchase is totally selective. The tender-offer is selective insofar as the company can define enforceable criteria. The criteria must be those that the company can enforce, such as the number of shares held -- the company could not determine, for instance, if shares tendered belonged to dissidents or did not. As will be seen below, the alternatives to selectivity in reacquisition are (i) the use of a method such as the open-market method which is entirely unselective and operates by chance, and (ii) the use of totally proportional reacquisition, which effectively results in the reacquisition of an equal fraction of each shareholder's holdings. Selectivity is an integral part of many of the objectives of stock reacquisition, as well as an integral factor contributing to the implications for the shareholder of the reacquisition transaction.

The open-market method is the one used most often, with private purchase second and tender offer third.[42] Rapp, based on his study of repurchase activity for the period 1951 to 1962 concluded that open market purchase was the major method, direct purchase second, (but far behind open market purchase), and public-tender third. When compared to the number of shares and dollar value of shares reacquired, (rather than the number of instances), the tender offer was more significant.[43] He found that approximately 73 per cent of the repurchases were made in the open market, approximately 20 per cent in direct negotiation, with the tender offer

accounting for 4 per cent of the repurchases.[44] However, the tender offer as a method of repurchase is of greater significance than the frequency of its usage would indicate, because the tender offer is normally used to reacquire relatively large amounts of shares. For the period 1951 to 1962, while tender offers accounted for only 4 per cent of the repurchase transactions, they accounted for 10% of the shares repurchased.[45] The tender offer is currently increasing in significance as a method of reacquisition.[46] Rapp concludes that "public tender offers have become more frequent in recent years as 20 of the 25, or 80 per cent (of the tender offers for the period 1951 to 1963) were made during the six-year period of 1958 to 1963, and all of those 25 were made in 1963".[47] The increased popularity of the tender offer may be due to the increased emphasis on disclosure by the SEC. For the same reason, an increased use of the tender offer may be expected with a resulting decline in open market purchase where relatively large amounts of stock are required, especially after the Genesco and Georgia-Pacific incidents discussed above.

E. <u>The public tender offer is the preferred method</u>.

In view of the significance of the price to be paid for the shares, that price should approximate the value of the share. Lacking an absolute measure of this value, the price should at least be an honest, objectively determined

evaluation, free from deliberate distortion. In this sense, the open-market purchase and the public-tender offer are superior to the direct private purchase. In an open-market purchase, the price paid is usually equal to the market price, and with the tender offer, the price is set with reference to the market price. In direct purchase, the price need not be limited by the market price. While the market price is not necessarily equal to the true value of the share, it is, in theory, a price objectively determined by the forces of supply and demand. As such, the market price reflects the judgment of many individuals as to the true value of the shares. These individuals include not only shareholders, but also non-shareholders who may have considered purchasing the shares of the firm, but have found the price to be too high, and have registered this opinion by not buying shares at the offered price. This market-determined price is more desirable than a negotiated price which reflects the judgment of only two parties, and which may reflect motives directly prejudicial to the operation of objective judgment on the part of either or both of those parties.[48]

The public-tender offer involves the fullest disclosure of information to the shareholder. The tender offer normally gives the most adequate disclosure of information on which to base a decision as to the relationship between the price to be paid and the value of the share. This normally includes the

intent to repurchase, the number of shares to be repurchased, an indication of the price to be paid and an indication of the objective of reacquisition. Similarly, the tender offer may provide the most information concerning the impact on voting control, such as the number of shares to be repurchased, the objective of reacquisition, and an indication as to whether or not the shares will be re-issued.[49] The open-market method and direct purchase method do not ordinarily involve comparable disclosure.

The open-market and tender-offer methods both provide opportunity for shareholders to sell their shares to the corporation while the direct purchase provides this opportunity only to the specific seller involved in the transaction. In the open-market purchase, the corporation does not control the choice of shares to be purchased and all shareholders are offered equal opportunity to sell. The selection of shares to be purchased operates by chance, and if the repurchase is unannounced, this chance is available only to those who happen to be selling at the time. Because of the prior announcement of intent, the tender offer generally extends the opportunity to all shareholders to tender their shares. If more than the maximum number of shares is offered, then the shares will usually be taken pro-rata to the number offered, or those offered at the lower price which the shareholders themselves have set. This is a more effective extension of equal opportunity than pure chance, even though the reliance

on chance may be objective. The private purchase lends itself to the attainment of objectives which are clearly discriminatory as against other shareholders, such as the "bailing out" of major shareholders at a price in excess of the value of the interest sold. The direct purchase allows transactions with only selected shareholders, a situation which does not apply with the other two methods.

Accordingly, in terms of the effective opportunity for shareholders to protect their interest, the tender offer must be considered to be the preferred method of stock reacquisition. The more adequate disclosure of information involved with the tender offer makes the opportunity to sell shares meaningful and effective. Without the information needed to decide whether he should or should not try to sell his shares, the nominal opportunity to sell is of no consequence.

The objection may be raised that since, in open market purchases, the price is equal to the market price, then the opportunity to sell at that price exists whether or not the shareholder is aware that the corporation is buying. The existence of the opportunity to sell in the market cannot be denied, but this is not the total picture. The decision of whether to sell is different when it is known that the corporation is going to reacquire shares than when it is not, because the reacquisition may change the value of the shares held; without the shares being sold, a gain or loss can now

occur. In short, the decision cannot be made concerning the deliberate reaction to a reacquisition unless the reacquisition is known and information on which to base the decision is available. In this respect, both the open-market and direct purchase methods are inferior to the public tender offer.

In respect to voting position, the tender offer is preferred because of the fuller disclosure involved. The lack of relevant information involved with the other two methods renders the shareholder unable to appropriately adjust his shareholdings, even though the opportunity to sell or retain his shares may exist.

In summary, the public-tender offer would appear to be the preferred method of reacquiring shares in that the characteristics of this method are such as to best enable the shareholder to protect his interest in the corporation: (i) While the price is not necessarily equal to the value of the shares, the price is set at, or with reference to, the market price; (ii) The public-tender offer involves the fullest disclosure of information relevant to the decision concerning the sale of shares; (iii) The public-tender offer extends an opportunity to shareholders to participate in the sale of shares to the corporation and makes this opportunity effective by fuller disclosure. Where it is necessary to select specific shares from among those offered for sale, the selection is pro rata to shares tendered or by reference to the price set by the shareholder.

III- The formulation of public regulation.

The ultimate objective of this study is the formulation of public regulation concerning the reacquisition of its shares by a corporation. The analysis has to this point dealt with the implications of reacquisition for the individual shareholder, and must now be focussed on the total shareholder group. The effectiveness of the various methods of reacquisition in protecting the total shareholder group -- rather than the individual shareholder -- must now be considered. What are the implications for the shareholder group and what conditions must apply to eliminate those implications considered objectionable?

A stock reacquisition may be the direct cause of inequity among the members of the shareholder group. As a direct result of the reacquisition of shares by the corporation, one shareholder may enjoy a gain (suffer a loss) at the expense of (to the benefit of) another. It is not unreasonable to assume that shareholders involved in reacquisition will act in such a manner as to maximize their benefit -- rather than so as to merely protect their interest -- and if one gains, another loses. Not only may one shareholder suffer a loss in favour of another, but even more importantly, he does so as a direct result of a transaction between the corporation as corporation and the shareholder as shareholder. Furthermore, this gain/loss, and the attendant voting position implications, may result from a transaction to which the shareholder is not a

party and of which he is not even aware. Whether this potential inequity is of such a nature as to warrant steps to eliminate its occurrence is discussed below; here, the conditions which would be necessary to eliminate the inequity will be considered.

If the possibility of inequity between shareholders as a result of reacquisition is to be avoided, then either shares must be reacquired in such a manner as to preclude the inequity or reacquisition transactions must be eliminated. As demonstrated above, inequity will be eliminated if either:

i) the price paid for the shares is equal to the value of the shares, or

ii) the repurchase is proportional to all shareholders, in which case the voting position implications are also eliminated.

Barring a price equal to the value of the share, and lacking strictly proportional reacquisition, each and every shareholder would be protected only if both of the following conditions apply:

i) Each shareholder must make the correct decision as to the relationship between the price of the shares and the value of the shares. It is not enough only to ensure the adequate disclosure of information so as to enable the shareholder to make the correct decision -- does he have the knowledge and

ability to use the information to make the correct decision?

ii) Each shareholder must have the opportunity to sell or refrain from selling the appropriate fraction of his shares. All must have the opportunity to sell -- not only to tender, or to have an equal chance of having their shares selected -- but to actually sell the appropriate shares.

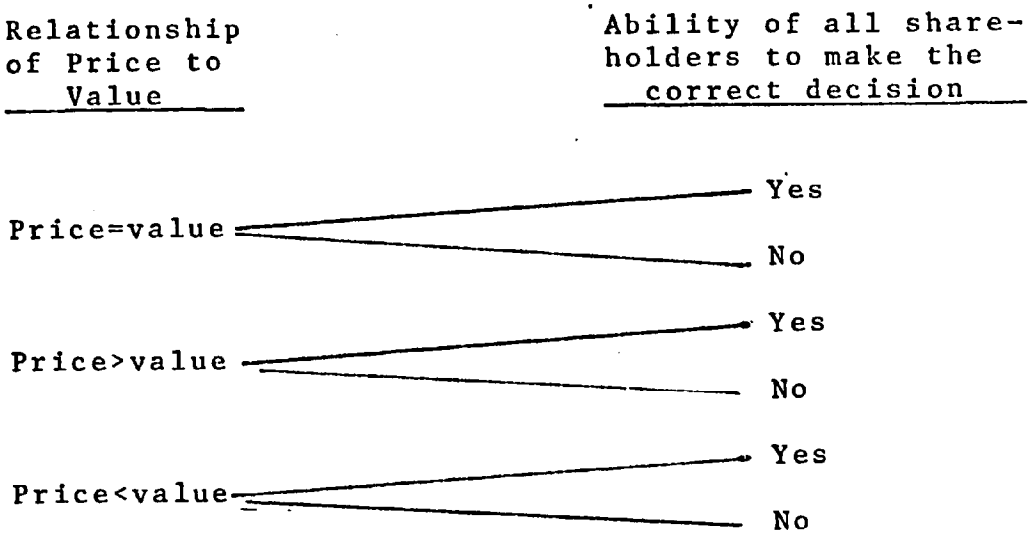
In determining a basis for public policy, it must be decided whether these conditions currently obtain or if they could be made to obtain. In doing so, the following alternatives will have to be considered:

i) Is the share price equal to the share value, higher, or lower?

ii) Are the shareholders able to make the correct decisions as to the relationship between share price and share value, or are they not?

iii) Given the combinations of these alternatives, are the practical methods of reacquisition effective in providing the opportunity to sell shares?

The alternative cases to be considered can be outlined as follows:



A. The relationship between price and value.

Price equal to value.

If it is assumed that the price paid for the shares is equal to the value of the shares, then there is no possibility of gain or loss by any shareholder. In that case, the opportunity to sell shares is of no significance, regardless of whether or not all shareholders are capable of making the correct decision about the relationship between share price and share value. If all shareholders can make the right decision as to price, the opportunity to sell will be met with indifference. Even if all shareholders cannot make the right decision, no gain or loss will be involved for any shareholder.

Price greater than value.

If the share price is greater than the share value,

then each shareholder must sell the proportionate share of his holdings simply to protect his interest and each shareholder must actually sell only the proportionate part of his holding.

If all shareholders can make the correct decision concerning the relationship between the share price and value, then all shareholders can be expected to try to sell all their shares. If one shareholder is successful in selling more than his proportionate share, then some other shareholder will be unable to protect his interest.

If all shareholders cannot make the correct decision, then some may erroneously decide not to sell shares -- as they must do simply to protect their interest -- and others will be able to sell more than the proportionate part of their holdings.

Accordingly, if price is greater than value, proportional reacquisition is necessary to eliminate inequity, whether or not the shareholders can make the correct decision.

Price less than value.

If the share price is less than the share value, then the individual shareholder will lose if he sells more than the proportionate share of his holdings, will gain if he sells less, and will maximize his gain by selling none of his shares.

If all shareholders can make the correct decision as to the relationship between price and value, then it is to be ex-

pected that all shareholders will choose to retain their shares, and none will be sold at that price. Given the assumption of the correct decision, no shares would be made available for corporate repurchase by the shareholders, and the method of reacquisition would be immaterial.

If all shareholders are <u>not</u> capable of making the correct decision, then strict proportionality is required to prevent inequity. Some shareholders might, in error, consider the price favorable and attempt to sell their shares. Those correctly deciding the price to be unfavorable would thereby sell less than the proportionate part of their holdings (none), allowing other shareholders to sell more. Accordingly, inequity would result unless the reacquisition was strictly proportional.

The effect of these assumptions on the need for strict proportionality can be summarized as follows:

Relationship of Price to Value	Ability of all shareholders to make the correct decision	Proportionality
Price=value	Yes	Not necessary
	No	Not necessary
Price>value	Yes	Necessary
	No	Necessary
Price<value	Yes	Not necessary
	No	Necessary

Of these six cases, which are practically relevant? It would appear reasonable to treat as irrelevant those cases which are based on the assumption that the price paid is necessarily equal to the value of the share. As the basis for the formulation of public policy, that assumption would be difficult to justify. Given the nature of the determinants of share value, the nature of the valuation process and the nature of the objectives of reacquisition, the equality of price and value would be almost coincidental. The practical equality of price and value would require the ability to determine with certainty the share value, as well as the intention to pay a price equal to share value. There currently exists no share-valuation model which enjoys general acceptance, and as will be seen in Chapter VII, the deliberate inequality between price and value is an integral part of many of the objectives of reacquisition. Market value is not a sufficient and adequate measure of share value, mainly because the market which generates this price must itself rely on imperfect valuation models. Although the market may reflect a large number of opinions, many of the opinions are ill-informed, based on little understanding of valuation procedures, and subject to non-rational psychological influences. The whole theory of security analyses is based on the premise that market value is not necessarily the measure of a share's value; if it were, then all shares would be an equally attractive investment[50] and there would be little

reason to evaluate securities through analysis. The Courts have demonstrated an unwillingness to accept market value as the sole measure of share value and have looked to various valuation procedures for aid.[51] Where market value is used, it is considered as defensible evidence of the share's value, not as an incontrovertible measure of the value.[52] At the present time, it would be difficult to justify the assumption that in reacquisition the share price is necessarily equal to share value, and the cases based on these assumptions will be discarded. The relevant cases remaining are those where the price is greater or less than the share value.

B. <u>The ability of all shareholders to make the correct decision</u>.

The remaining question is whether or not shareholders can be assumed to be able to make the correct decision concerning the relationship between share price and share value. If the answer is assumed to be negative, then strict proportionality of reacquisition is required to prevent inequity from occurring, regardless of whether the price is greater or less than the share value.

As a basis for public policy, it would be difficult to defend the assumption that all shareholders are able to make the correct decision concerning the relationship between share price and share value. In order for this assumption

to be valid, several conditions would have to apply. First, all relevant information required as a basis for this decision would have to be disclosed by the corporation. Second, this disclosed information would have to be effectively available to each and every shareholder -- it must, in fact, come into his possession. Third, given this information, all shareholders must be capable of determining the exact value of the corporation and of its shares. In order for the shareholders to be able to do so, they must know the procedure which allows an exact determination of the true value of the shares. In order for this to apply, there must exist such a procedure and all shareholders must be capable of using it. It is difficult to assume either of these conditions. A review of the literature of corporation finance quickly indicates the lack of agreement among the authorities -- both in theory and in practice -- about the proper method of determining the value of corporation shares. Different authorities have suggested valuation procedures based on dividends per share, cash flow per share, the supply and demand for shares. Even if one of these approaches were considered to be the proper method, a review of the literature indicates again the complexities involved in the practical application of these theoretical approaches.

The definition of the information relevant to the decision is a major source of difficulty, and the matter of adequacy of disclosure, is another. In view of these ques-

tions, the cases based on the assumption that all shareholders can make the correct decision can be discarded. The cases remaining are those in which all shareholders are not capable of making the correct decision, and in which the share price is either greater or less than the share value. In both of these cases, strictly proportional reacquisition is required to prevent inequity.

C. Proportional reacquisition.

The public tender offer does not ensure strictly proportional reacquisition, although it involves the most significant extension of the opportunity to sell. All shareholders may not tender their shares, and untendered shares are not available for purchase, regardless of how the corporation selects shares from among those tendered. If the shares tendered exceed the maximum stipulated, then at best, shares will be purchased pro rata to the number of shares tendered rather than the number of shares owned. The purchase of shares in the order of the lowest price offered is totally unrelated to the proportionality of the holdings. A public tender offer would result in a strictly proportionate reacquisition only if all shareholders tendered an identical fraction of their holdings to the corporation, and the actual repurchase were proportional to the number of shares tendered.

Because the public tender offer does not ensure a proportional reacquisition, it does not ensure the prevention

of inequity in the reacquisition of shares. The open-market method does not prevent inequity in reacquisition, since it involves no assurance that all shareholders will sell the proportionate share of their holdings. Here again, the point can be made that the opportunity to sell is extended equally and objectively to all shareholders, and this is true. However, the opportunity for proportional reacquisition is not enough -- reacquisition must in fact be proportional -- and with the open-market shares to be purchased are selected by chance. The direct private purchase, by definition, does not result in proportional reacquisition. It follows that the currently practical methods of reacquisition are ineffective in preventing inequity among shareholders.

In respect to the question of voting control implications of reacquisition, the tender offer and the other methods of reacquisition are ineffective since they do not ensure proportional reacquisition. The individual shareholder may improve his voting position by retaining all of his shares, should he have the knowledge to do so, and the voting position of some other shareholder is thereby weakened. Only proportionate reacquisition will eliminate the voting control implications, and this is not necessarily achieved with conventional methods of reacquisition.

The question remains as to whether the potential inequity among shareholders is significant enough to justify the measures necessary to eliminate the inequity. The means of

eliminating the inequity -- proportional reacquisition -- would automatically eliminate all those objectives which require non-proportional reacquisition. The proportionality requirement would preclude the use of open-market and direct purchase as methods of reacquisition, and a strict application of proportionality would require fundamental changes even in the public tender offer. Because of this potential impact of the proportionality requirement, the consideration of this question will be delayed until after the examination of the objectives of reacquisition in the next chapter. By that point, several relevant questions will have been considered: What are the objectives of reacquisition? Are they desirable and legitimate objectives of corporate management? Which objectives would be affected -- and how -- by the proportionality requirement? Of the desirable objectives, which could be attained by other means? Of the undesirable objectives, which would be eliminated by proportionality? These things must be considered before the ultimate question can be answered; whether the desirable effects of those objectives which can be attained only by reacquisition are such as to outweigh the undesirable effect -- the potential inequity among shareholders.

Footnotes

1. Assuming a reacquisition of less than 100% of the outstanding shares, since if 100% of the shares were reacquired it would necessarily mean that 100% of each shareholder's

holdings were reacquired -- thus, necessarily proportional.

2. See Appendix IV for the formula for the calculation of the impact of reacquisition on voting position.

3. See discussion of the current significance of various methods of reacquisition below in this chapter.

4. The corporation might offer a small premium above the current market price to ensure getting the total amount required, or to ensure getting it within a short time. This indicates only a question as to the proper definition of the market price; the significant point is that negotiation, as it is normally understood, is not involved, and that the price paid is strongly related to the market price.

5. According to Young, "...the essential feature of an open market purchase which distinguishes it from the other two methods by which a corporation can reacquire its own stock is that, at least at some point, the services of a broker are utilized and the transaction is executed on the floor of the exchange." p. 27.

6. Should the corporation pay a small premium, it could be only by chance that any particular shareholder would be the recipient of the higher price. Furthermore, should the premium paid be material, in either the magnitude of the premium, or the number of shares purchased, it could be expected to effect, to some extent, the "market" price, moving it upward. This would tend to make this price available to any shareholder wishing to sell his shares.

7. Guthart reports, "Of the 15 companies considered the most active repurchasers during the past decade, 10 companies made all of their reacquisitions via the open market method. Of these 10 companies, 2 gave no notice at all to their shareholders. The other 8 companies gave their shareholders some degree of general notification of their intention to repurchase stock. This notification typically took the form of brief statements in the annual report regarding the company's past purchase activities and its intention to continue repurchasing outstanding shares. None of the companies in this group gave direct notice at the time of repurchase and rather only made general statements to their shareholders regarding their reacquisitions." Dissertation, p. 218.

8. See discussion above in Chapter IV. Form 8-k must be filed only if the change in shares outstanding is 5% or greater. The N.Y.S.E. requires reporting only of purchases made above the market price, thus rendering this ineffective as against open-market purchases.

9. Guthart, dissertation, pp. 217-221.

10. Young, p. 27.

11. "Timely Disclosure", Mergers and Aquisitions, II, No. 3 (Spring 1967), pp. 10-14, p. 12.

12. Guthart, dissertation, p. 221.

13. In any given case, the price needed to attract the desired number of shares would be a function of the relative number of shares required, and the shape of the supply curve for the shares. The shape of the supply curve would be a function of the estimate of the true value of the shares held by the shareholders. The existence of a stable market price (on which to base a tender offer) implies only a short-run equilibrium, but says nothing about the elasticity of the supply curve.

14. Wall Street Journal, October 22, 1965, p. 2.

15. Zilber, University of Cincinatti Law Review, XXXIII, p. 318, n. 15. The source of this information is an interview with a director of the firm; the interview conducted by Zilber, p. 380.

16. Zilber describes the tender offer as follows: "A tender offer may be either a firm or conditional offer inviting shareholders to submit all or part of their stockholdings for purchase by the company. The offer may be conditional on the tendering of a certain number or proportion of the total shares outstanding. The offer is usually limited in time, usually to a month or less, with an option in the corporation to extend the period. The offer is usually limited to a maximum number of shares or a maximum amount to be spent in reacquisition. A maximum price is usually set at or above the market price. Provision is made for the selection of shares to be purchased, if more than the maximum number of shares are tendered; if all shares are to be bought at one price, the shares will usually be purchased pro rata to the number tendered; if shares are to be tendered to be bought at the lowest price offered, then the problem is automatically solved. Acceptance of the tender offer by the shareholder is accomplished by forwarding his share certificates to the designated transfer agents of the corporation. In exchange for the shares, the corporation may offer cash, bonds, stock of a different class in the corporation, stock or bonds of another corporation, or some combination of these items." p. 316.

17. Wall Street Journal, December 17, 1962, p. 22.

18. Ibid., January 8, 1963, p. 29.

19. Ibid., November 5, 1965, p. 28.

20. Young, in his study, found a significant positive correlation between the premium on a tender offer and the degree of mutual acceptance of the tender proposal. p. 33, and pp. 104-5.

21. Wall Street Journal, December 9, 1965, p. 30.

22. Ibid., December 20, 1965, p. 14. It is also worth noting the length of time the offer was open -- from December 20, 1965 to March 30, 1966. This is not unreasonable, given the relative size of the intended reacquisition.

23. Merjos states that when the purpose of the offer is simply to add stock to the treasury, the premium is usually small. However, the premium is raised when control is at stake. Anna Merjos, "No Tender Trap", Barrons (January 25, 1965), p. 9.

24. "They're Buying Themselves", Forbes (December 15, 1965), p. 38.

25. Wall Street Journal, February 1, 1968, p. 9.

26. United Fruit announced January 8, 1963, deadline January 28, 1963. Ryder Systems Inc. announced October 22, 1965, deadline November 12, 1968.

27. Hilton Hotels extended the offer time, as had been provided for in the original offer. WSJ Jan. 8/63, p. 8. Mangood Corp. said that the offer expired Feb. 28/66, but might be extended to March 31/66 -- the offer was announced Dec. 20/65.

28. Wall Street Journal, December 9, 1965, p. 32. Actually 4,118,000 were tendered, only 1,000,000 required, and the purchases were pro-rated at about 24% of those tendered.

29. Ibid., January 16, 1966, p. 18. Zapata Offshore Co. used the same approach, saying it would purchase all shares tendered up to 300,000, and reserves the right to purchase more if tendered. WSJ. Feb. 11/65, p. 9.

30. Ibid., December 6, 1965, p. 13.

31. Ibid., November 5, 1965, p. 28.

32. Ibid., January 6, 1966, p. 18.

33. Ibid., February 11, 1966, p. 13.

34. Ibid., November 4, 1965, p. 3.

35. Ibid., October 22, 1965, p. 30.

36. The N.Y.S.E. Listing Agreement and the N.Y.S.E. Company Manual. The American Stock Exchange has highly similar provisions, American Stock Exchange Listing Form L.

37. N.Y.S.E. Manual -- at A-170.

38. Wall Street Journal, November 22, 1965, p. 12.

39. Ibid., November 23, 1964, p. 30.

40. This is true, strictly speaking, within this specific transaction. In fact, however, the corporation might be willing to enter into such transactions with other shareholders.

41. A tender offer is used to invite small shareholders to tender their holdings -- to approach each directly would be too costly and time-consuming. Where the aim is to purchase shares of a dissident shareholder, only the direct-purchase will be effective.

42. Zilber, University of Cincinatti Law Review, XXXIII, p. 317; Guthart, dissertation, pp. 217-218.

43. Rapp, pp. 205-6. It would be extremely difficult to accurately report the statistical results reported by Rapp without completely reproducing his data. He dealt separately with samples of corporations in the industrial, financial, transportation and utility sectors. Further, he dealt with the number of repurchases, as well as with the number of companies, since some companies used more than one method. His individual tables are extremely difficult to interpret, and attempts to combine and summarize these results would not result in a product sufficiently definable to be useful. The reader is referred to pp. 191 to 206 inclusive, in Rapp's study, where full reference is made to the data supporting the results reported there.

44. Rapp, p. 248. These percentages do not round to 100, the author speaking in round terms. See footnote immediately above.

45. Ibid.

46. Guthart dissertation, p. 222. Zilber states, "While by and large most...acquisitions have been authorized in the open market, recently an increasing number of corporations

have resorted to the more formal method of seeking tenders of large blocks of stocks directly from their shareholders." pp. 315-316.

47. Rapp , p. 249.

48. For example, shares may be acquired by direct purchase from dissident shareholders, or shareholders threatening a proxy battle, in which case the price may well be set only with an eye to maintaining management's position, or to eliminating embarrassing opposition.

49. If, for instance, the objective is to have shares available for distribution as a stock dividend, this is different from the objective of the permanent reduction of capital. In the first case, the shares will be reissued pro rata to shareholders; in the second case, they will not be reissued.

50. In terms strictly of the price-value relationship. The securities might differ in respect to income and capital characteristics which might be more or less suitable to a specific investment need and portfolio policy.

51. Baker and Cary, pp. 1098-1100. Norman D. Lattin, The Law of Corporations (Brooklyn, The Foundation Press, 1959), p. 528.

52. Lattin, p. 529.

CHAPTER VII

The objectives of reacquisition.

Some of the objectives of stock reacquisition are achieved by a reacquiring of shares, others by a reacquiring and reissue of shares, and still others by a combination of buying, holding and/or selling of shares. In this chapter, the objectives have been classified so as to allow consideration of groups of objectives as well as individual objectives. Thus, the implications of the use of stock reacquisition to affect shareholder relations in general, as well as specifically to "buy-off" derivative suits will be examined.

Corporations reacquire shares for the following purposes:[1]

(1) To effect a distribution of corporate funds:
   a) as a partial liquidation
   b) in place of ordinary dividends
(2) To improve a corporation's financial position or performance:
   a) by increasing the debt/equity ratio
   b) by directly increasing book-value or earnings per share
   c) by supporting or increasing the market price of its shares

(3) To be able to re-issue reacquired shares rather than new shares:

a) to satisfy the requirements of stock-option, stock-bonus, or employee stock-purchase plans

b) for use in mergers and other non-cash acquisitions of assets

c) for later issue as stock dividends, or to be available to meet the terms of convertible security issues or outstanding stock warrants

(4) For the benefit of controlling shareholders;

a) to enhance the value of the controlling groups interest

b) to strengthen the voting position of the controlling shareholders

c) to enable a major shareholder to reduce his holdings

(5) To defeat the threat posed by the corporate "raider".

(6) To eliminate dissenting shareholders:

a) in accordance with appraisal remedy provisions

b) in other than appraisal situations

(7) Reacquisition for miscellaneous purposes:

a) trading in shares

i) short-term investment of idle funds

ii) to manipulate the market price of shares

b) to decrease the number of small shareholdings

c) in settlement of a debt

d) to eliminate fractional shares

e) to accept shares received as a gift

Each of the objectives listed above will be described and the contributing economic, legal and regulatory factors indicated, referring where necessary to relevant material in Chapters III to VI. In those cases in which the objective appears to be a desirable one, the availability of alternative means of achieving the objective will be considered also.

During the course of the analysis, it will become obvious that specific reacquisition transactions may be carried out for a combination of objectives. This in no way invalidates the isolation and examination of individual objectives, or the separating out of the specific objectives for the purpose of understanding the transaction as it occurs in the present legal, regulatory and tax environment. In practice, failure to isolate the constituent elements of a complete transaction -- of which reacquisition may be only a part -- can lead to misunderstanding of the nature of the transaction and its effects on the corporation and its shareholders.

Recently completed studies by Guthart and Rapp provide information on the relative practical significance of objectives. Guthart, in an article based on the analyses of share repurchase activity in 1964, 1965, and 1966, directs attention to the reasons for corporate repurchase of common stock, and lists the objectives in the order of their signi-

ficance:[2]

(1) To shrink the equity base -- the desire to reduce the equity capital of the company. These were generally companies which had accumulated redundant funds.

(2) To avoid increasing the equity base in the future -- to satisfy

a) stock options

b) acquisitions

c) convertible debentures and warrants, and stock dividends

(3) To make a good investment (the yardstick most relied on was book-value).

(4) To support the market.

(5) To eliminate small stockholders.

(6) To obtain or improve control.

Rapp's study summarizes the reasons for repurchase, and reports the number of times reason given for repurchase as a per cent of the total number of repurchases as follows:[3]

Merger	31.8
Avoid dilution of eps	26.2
Best investment opportunity	19.2
Avoid losing control	1.4
Eliminate small shareholding	1.7

Combined avoid dilution, merger, investment	8.1
Other	11.6
	100.0

Rapp also did a study of the uses to which treasury stock had been put during the period December 31, 1950 to December 31, 1964. His conclusions are summarized in Table 4.[4]

TABLE 4.

Uses of treasury shares as a percent of total uses.

	Industrials	Financial	Transportation	Utilities
Mergers	31.3	36.4	10.0	40.0
Stock Options	33.3	22.8	55.0	60.0
Cancellations	10.0	13.6	25.0	----
Stock Dividends	4.0	13.6	5.0	----
Employee plans	18.6	13.6	----	----
Miscellaneous	2.8	----	5.0	----
	100.0	100.0	100.0	100.0

As seen, the merger and stock options were the most significant uses of reacquired stock during the period, with cancellation third.

Conclusions of the two authors are essentially in agreement. Both rank the avoidance of dilution and mergers as the most important reasons for reacquisition, although ir

conflicting order. They likewise both rank reacquisition as investment in third place, and control and the elimination of small stockholdings as a relatively minor significance.

I - Reacquisition of shares to effect a distribution of corporate funds.

There are two situations in which reacquisition may be used for the sole purpose of distributing corporate assets to shareholders. In both cases, an ordinary dividend could be used and in both cases the main reason for the use of reacquisition is the expected income tax advantage to the shareholders. In the first situation, the corporation wishes to effect a partial liquidation of the corporation and in the second the corporation decides to reacquire shares rather than pay an ordinary dividend.

A. Partial liquidation.

Academic authors have recognized the tax advantage of reacquisition as a means of partial liquidation[5] and management has utilized reacquisition for this purpose.[6] As discussed in Chapter V, a distribution may not qualify as a partial liquidation for tax purposes, even though a major part of the corporation's assets have been disposed of the activities significantly curtailed, and a significant portion of the corporation's assets distributed. If the distribution is not eligible for capital gains taxation by virtue of quali-

fying as a partial liquidation, then the distribution must be other than pro rata to allow shareholders to qualify individually for capital gains treatment.

Advantages other than the tax advantage can be cited for the use of reacquisition in the place of a dividend, and these apply equally to the case of a partial liquidation that does qualify as such for income-tax purposes. Repurchase may have a more favorable effect in supporting the market price of the shares than would a liquidating dividend.[7] This however, amounts to an attempt by the corporation to influence its share price through direct intervention in the market, which is not generally considered to be a legitimate action of the corporation.[8] Too, the use of a pro rata liquidating dividend results in the return of a portion of corporate assets to every shareholder, and this may be undesirable to some. Reacquisition has the advantage of distributing assets only to those hwo are willing to sell their shares. However, this point does not seem very significant in the case of the widely-traded publicly-held corporation, since the shareholder who wishes to sell his holdings can do so, and the shareholder who receives a liquidating dividend can reinvest the capital by purchasing more shares.

B. Reacquisition instead of an ordinary dividend.

It has recently been recognized -- by both academics[9]

and corporate management[10] -- that repurchase may be an alternative to the ordinary dividend distribution. The general reasoning is that reacquisition has the same net effect as a dividend -- the assets flow out of the corporation and into the hands of the shareholder group -- with the addition of a tax advantage. While the several authors are not in complete agreement as to the extent of the advantage, they do agree that it exists. In theory, the tax advantage is expected to result in relative increases in the total market value of the corporation, which means that all shareholders will share in the advantage and not just those who sell their shares.

There may also be non-tax advantages to the use of reacquisition rather than an ordinary dividend. A dollar of dividends may have a greater impact on the market value of the firms' shares than a dollar spent in reacquisition.[11] The converse may also be true. The relative effect of reacquisition would be a function of the amount of the distribution, the size of the float, the size of the ordinary dividend and other factors. When repurchase is used in lieu of a "large" dividend, it involves no indication that the regular dividend will be increased, as might a dividend distribution at a "higher" rate.[12] However, such a dividend could be clearly labelled an "extra" or "special" dividend.

One disadvantage of dividends is that they constitute mandatory receipts of cash to all shareholders whereas not

all may want cash.[13] On the other hand, those who are satisfied shareholders and who desire cash should be able to receive it without having to sell their shares. (These are not shareholders of a "growth" company who see that earnings are being retained to finance the growth -- earnings are being distributed, but continuing shareholders are not receiving the distribution.) The use of reacquisition, in effect, would appear to operate for the benefit of those shareholders who are willing to surrender their position by selling their shares. It would seem more reasonable to determine distribution policy for the benefit of the satisfied continuing shareholders.

It is unlikely that reacquisition will come to be considered a "normal" alternative to an ordinary dividend distribution by the management of publicly-held corporations. The payment of an ordinary dividend, a relatively simple matter, is objective in its equal treatment of all shareholders, does not involve the corporation in repurchase transactions and problems of disclosure, and is not subject to the criticism that distribution is made only to the selling shareholders.

C. The acceptability of tax avoidance.

The main reason for the use of reacquisition rather than a dividend distribution is to avoid taxation at ordinary income tax rates of corporate distributions to shareholders.

This is contrary to the general spirit of the income tax law since, as a general rule, any distribution to a shareholder by a corporation out of "earning and profits" is intended to be treated as ordinary income to the shareholder and taxable at ordinary income tax rates.[14] A distribution is not taxable as ordinary income if it is not deemed out of "earnings and profits" but all distributions are normally considered as being out of earnings and profits until earnings and profits are exhausted.[15]

"Earnings and profits" is related to but not necessarily the equivalent of earned surplus as determined in accordance with corporation law or generally accepted accounting principles.[16]

In determining the figure, appropriate amounts may be deducted on account of distributions by a corporation in partial liquidation or in redemption of its stock. However, only those distributions which are treated as dividends in the hands of the shareholders are allowable as deductions in computing accumulated earnings and profits.[17] Therefore, if a reacquisition qualifies for capital gains treatment, it does not reduce the accumulated earnings and profits of the corporation. This point is important, because it means that a corporation can exhaust its surplus available for distribution (as defined by corporate statute) by stock repurchase, without reducing its accumulated earnings and profits.[18] It is even more significant in indicating the

general intent that distributions out of accumulated earnings be taxed in the hands of shareholders as ordinary dividends; since a distribution which is (for any reason) eligible for capital gains treatment in the shareholder's hands does not reduce earnings and profits, that amount of earnings and profits is deliberately eligible to be taxed as ordinary dividends in the future. This intent is further evidenced by the existence of the accumulated earnings tax.

The accumulated earnings tax is intended to prevent unreasonable accumulations of corporate earnings for the purpose of avoiding personal income taxation at the shareholder level.[19] The tax is imposed on "every corporation ...availed of for the purpose of avoiding income tax with respect to its shareholders...by permitting earnings and profits to accumulate instead of being divided or distributed".[20] The fact that earnings and profits are allowed to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid income tax on its shareholder, unless the corporation proves to the contrary.[21] Liability for the tax turns on the intent of the corporation, which is primarly a question of fact, and dividend policy is one of the factors considered in determining whether the tax avoidance purpose was present.[22] While dividend policy would only be evidence as to the question of accumulation, it would be significant where repur-

chase has been used in lieu of dividends. Although this tax has traditionally not been applied to the publicly-held corporation, this situation need not continue. It is understandable that in practice, it would be the close-corporation where this would be most often found, and where the intent might be most easily demonstrated. However, it would seem reasonable to expect that these provisions might be applied to publicly-held corporations, should reacquisition become significant enough in the eyes of the Internal Revenue Service to warrant such attention.

Whether in fact the present provisions will be applied to the publicly-held corporation is not the significant point. The general spirit of the Internal Revenue Code is that all distributions to shareholders out of earnings and profits are to be taxed in the hands of the shareholder as an ordinary dividend at the ordinary tax rate.[23] The use of reacquisition to achieve the more favorable tax treatment is contrary to this general spirit and is in that respect objectionable.

It should be noted that where the tax result is the reason for reacquisition, it is necessary to use non-proportional reacquisition, and this provides opportunity for inequity among shareholders. This potential inequity is not present with the use of the most obvious alternative form of distribution, the ordinary dividend, which is proportional.

If it is in the public interest that all distributions in partial liquidation be eligible for favorable tax treatment, then the Code and Regulations should be appropriately amended so that this can be accomplished without the attendent danger of inequity. If such tax treatment is not in the public interest, then it should not be attainable by the use of the reacquisition transaction.

In summary, this objective of reacquisition is objectionable in that it is aimed at tax avoidance. An alternative means of distribution is available, the ordinary dividend, which by its proportionality would preclude inequity among shareholders.

II - Reacquisition to improve the corporation's financial position or performance.

Here the objective is to take advantage of the direct effects of reacquisition to improve a corporation's financial position or performance. The measure of position/performance may be book-value per share, earnings per share, or even the market price of the corporation's shares. The intent may be to increase eps or book-value directly by buying shares at a low price, to increase the leverage in a corporation's financial structure, or to increase the market value of the shares by its own purchase.

A. To increase the leverage.

The principle involved is simply to increase the corporation's debt/equity ratio by decreasing the equity rather than by increasing the debt. If the corporation has redundant funds, all that is involved is their distribution by repurchase of shares. If the corporation requires all the funds it possesses, then the repurchase may be financed by new debt capital issued for that purpose. Ryder Systems Inc. used the first route, simply reacquiring shares for the purpose of improving the company's capital structure.[24] Pittsburgh and Lake Erie Railroad reacquired its shares and financed the purchase from unsecured bank loans and treasury cash.[25]

The objective -- the use of the leverage -- is an accepted part of corporate financial management, but it can be achieved by means other than the reacquisition of stock. Reduction in the number of shares outstanding is unnecessary for the accomplishment of the essential part of the operation, the distribution of equity capital. This distribution can be accomplished by the payment of an ordinary dividend which would be proportional and would therefore preclude the occurence of inequity among shareholders.

Thus, it becomes a question of reacquisition versus dividend distribution, and of income-tax avoidance -- reacquisition for tax advantage rather than reacquisition

for leverage.

B. Repurchase to support the market price of shares.

Such repurchases are considered by some to be a legitimate corporate transaction, presumably carried out for the benefit of the corporation and its shareholders. The selling shareholders will benefit from a higher price and the corporation benefits via its credit rating and a "good" market in which to raise additional capital. Guthman and Dougall suggest that, for the corporation whose earnings and market value have declined, purchase of stock by the company is more likely to lift or sustain market price than would a dividend.[26] They further suggest that "even companies with reasonable earnings may face the question of whether some portion of earnings might not properly be devoted to repurchase of common stock" for the same reason.[27] Another author states, "of course, a great many companies regularly go into the market-place. When their management feel their securities are being undervalued, it is a good time to buy treasury stock...Besides, management has an obvious -- and presumably legitimate -- interest in seeing that its stock is properly valued by investors."[28]

Even though such repurchases may be for the benefit of the corporation and its shareholders, they

raise certain questions. The first is the acceptability of the corporations' action in directly affecting the price of its shares by its own purchases. Since this is stated as the objective, it must be assumed that the price which results is different from what it would have been had the corporation not intervened in the market as a buyer. If so, this procedure falls within the range of activities aimed at "artificially influencing the market price", which is generally considered to be undesirable. The legality of such transactions are discussed on page 236.

The theory of corporate financial management holds that the objective of management is the maximization of the wealth of shareholders. This includes maximization of the market value of the shares and of dividend distributions. However, maximization of the market value of shares does not extend to driving up market price by repurchase. Rather, it is intended that the price be maximized by operating the company in such a manner as to maximize its earnings and so maximizing the amounts which investors are willing to pay for rights to residual positions in a corporation. Maximization of earnings involves the economically-efficient utilization of corporate resources. Maximization of the amount the investor will pay is a matter of several factors, dividend policy, operating policy, and information disclosure among them. Not nor-

mally included as an objective of management is the utilization of corporate assets to directly influence the share price by purchasing those shares in the market.

C. Repurchase to directly increase book-value or earnings per share.

The limited usefulness of book-value as a measure of the effect of reacquisition on the corporation was considered in Chapter III. However, the effect on book-value is used to a great extent by corporate management in assessing the desirability of repurchase. According to Guthart, this was the yardstick used by most corporations in making the repurchase decision -- "To the extent that the market price of stock fell below book-value, many managements reckoned that repurchase was an attractive investment."[29]

In a letter from the Continental Insurance Company to its shareholders, (quoted in part on page 187), direct reference is made to a net worth (at book-value) of $91.50 and a market value of $70.00 in demonstrating the benefit of reacquisition to shareholders. In an article discussing the impact of reacquisition on the performance of Crane Co. the increase in eps is attributed directly to the repurchase of shares at less than book-value.[30]

Since a change in book-value does not necessarily indicate a proportionate, or any, change in the real economic significance of the corporation, it is difficult to defend an increase in book-value as an objective of

reacquisition.[31]

Corporate management and academic writers have recognized that repurchase of shares at "low" prices can favorably affect eps. However, as demonstrated in the following quotations, the relationship between price and eps has been generally undefined:

> "...,some retained earnings may be profitably employed in the repurchase of common shares if their market price fails to reflect adequately their underlying asset value and earning power. Repurchases under such a condition may improve earnings per share with more certainty than through other investment opportunities."[32]

The Continental Insurance Company in a letter to its shareholders said:

> "The Company believes the purchase plan will be of benefit to shareowners. The net worth of the Company...approximates $91.50 per share...The current market price is about $70.00 per share. On the basis of these figures, share purchases will obviously serve to increase the net worth of the remaining shares in proportion to the number of shares being retired under the plan. Per share earnings should also show a relative improvement."[33]

Tishman Realty and Construction Co. purchased shares because it felt the stock was undervalued.[34] Crane Co. reacquired shares for the purpose of increasing eps, and did so successfully.[35] Zapata Off-Shore Co. explicitly stated in its offer to shareholders that purchases were being made to increase earnings per share of common stock remaining outstanding.[36]

Certain statements found in the literature imply that reacquisition necessarily increases earnings per share.

> "In the process of capital reduction, per share earnings is enhanced."
> 37

> "When a corporation repurchases a portion of its outstanding shares, its earnings per share must, as the result of this act, increase."
> 38

Stock reacquisition does not always increase earnings per share. As demonstrated in Chapter III, reacquisition will increase eps when the shares are bought at a price such that the earnings/price ratio, (r), is greater than the rate of return, (i), available on the assets distributed in repurchase. If i is assumed to be zero, eps will be increased by reacquisition regardless of the price paid for the shares. (Alternately, if the price paid is zero, eps will be increased regardless of how high i might have been.) There is a tendency to assume i to be zero where idle cash is present, but the proper value for i is the rate available on the best alternative use of the cash, if not distributed. In many cases, the decision to reacquire may appear to have been a sound one, since the eps is greater after than before the reacquisition. In reality, however, the eps might have been increased even more had the funds been retained and employed in the corporation. Such an opportunity-cost concept must be employed to properly evaluate the relative impact on eps of stock reacqui-

sition.

An approach based on opportunity costs and the best alternative use of the funds leads to the questionable concept of "investing in treasury shares". The repurchase of shares is often spoken of by corporate management as "investing in shares". Guthart cites "Stock Repurchases as a Good Investment" as the third most important reason why companies reacquired their shares. "On the basis of comparative calculations, these companies decided that share repurchase provided for them a more attractive investment opportunity than either investment in new plant or investment in other businesses."[39] That this was really considered an investment decision -- rather than a distribution of redundant capital -- is evidenced by the fact that "in some cases, funds were diverted from investments within the business to the repurchase of outstanding shares because the investment evaluation appeared so attractive."[40] "The repurchase of its stock by a company is an investment decision -- plain and simple. If a company can earn more per share for its shareholders by purchasing equipment or building a new plant, then the decision should be obvious."[41]

The technique for dealing with reacquisition as an ordinary investment alternative was demonstrated in Chapter III and need not be discussed here. However, the reacquisition decision is not an investment decision, but

a dis-investment decision. Reacquisition constitutes a decision to distribute assets to the shareholders, and given the "surplus rule", the source of these funds is normally retained earnings. Within the contemporary theory of corporate finance, the distribution decision is based not on the effect on eps, but on the maximization of wealth of the shareholder. In theory, the decision as to whether to retain and invest earnings or to distribute them to shareholders is made on the basis of whether the shareholders will benefit more by distribution or retention. This, in turn, is a function of the return available on the funds if retained and the return which the shareholders can earn on the after-tax dividends received. If the distribution is viewed as an investment and the decision made on the basis of the effect on eps, then a decision may result which is different from that made in accordance with the theory outlined above.

For instance; if i is assumed to be zero -- idle cash is present -- then the decision will always be to reacquire (distribute) since eps will be increased. If the approach is more sophisticated, and i is based on the best investment opportunity, then the decision would be to distribute where $r>i$, to the point where $r=i$. Contemporary theory, which takes account of the tax on the distribution in shareholders' hands, would not distribute to that extent, but would stop where $r>i$, somewhat short of $r=i$.[42] To that

extent, more funds will be distributed under the reacquisition approach then under the dividend approach.

Even without the tax effect on the recipient shareholder, the use of this single criteria -- the effect on eps -- may lead to results different from those based on maximization of shareholders' benefit. Where r is relatively "high" (share price is low) the decision to reacquire may be made simply because i is less than r, even though i might be substantially higher than the individual shareholder can get elsewhere. Alternately, where r is "low", assets may be retained because i is greater than r, even though i is less than the shareholder could get elsewhere.[43]

D. The validity of this objective.

Is the use of stock reacquisition for the purpose of improving the corporation's position a proper and legitimate part of corporate financial management? In general, is it acceptable for the corporation to attempt to improve its position, directly and deliberately, by means of a transaction with its own shareholders?

The acceptability of this objective can be questioned on several grounds. In the first place, the corporation itself is incapable of improving its position or performance. If a reacquisition should result in an increase in book-value or eps, it is the remaining share-

holders who benefit. Earnings per share or book-value is significant in speaking not about the corporation, but about the proportionate interest of the shareholder. Thus if the "corporation" has benefitted, it is really the remaining shareholders who have benefitted, and as seen in Chapter V, at the expense of the selling shareholders.

Assume for instance, that a corporation's management uses book-value per share as the criteria for deciding whether or not to repurchase its shares. If the market value declines below book-value, then management would begin buying shares. The motivation to purchase is the fact that the shares are selling for less than their value -- the book-value -- and the benefit to the corporation of buying. Has the corporation the right to buy, thereby paying <u>its own shareholders</u> an amount less than the share is worth? Not only is the amount less than the share is worth, but management feels it to be less, and with enough confidence to act on that feeling to buy shares. The question really is whether the corporation can legitimately act in such a manner as to benefit one group of shareholders at the expense of another.

The position is encountered that the corporation has done nothing questionable as long as the price paid to the shareholder is equal to the market price, since the shareholder sold willingly at a price equal to what he could

have gotten elsewhere. This position is open to question. It must be recognized that the reacquisition transaction is a transaction between corporation as corporation and shareholder as shareholder. The shareholder has a residual equity position and the corporation is supposed to operate for the equal benefit fo all shareholders.[44] As such, the value of the shareholder's interest is equal to his share of the total value of the corporation, whatever it may be and however difficult it may be to measure. The value of his interest is not necessarily equal to the shares' market price, and it is not necessarily appropriate to assume that the shareholder is fairly treated simply because he has been paid the market value of the shares. The Courts, as well as financial writers, have shown an unwillingness to accept market-value as the measure of the value of shares. Where market value is considered, it is used as one source of evidence concerning share value -- a readily available source -- but not as the irrefutable or exclusive source of such evidence.

The reacquisition transaction is distinctly different from an ordinary share transaction between two shareholders.[45] A shareholder who sells to the corporation at market price, willingly, might <u>not</u> be willing to sell <u>at that price</u> if he knew that it was the corporation that was buying. As shown in Chapter VI, the value of the remaining shares may change if the price paid on reacquisition is not equal to the share's value. Thus, unless the shareholder is aware that the corpora-

tion is buying, and has the knowledge of corporate facts and the ability to make a correct assessment, his decision to sell may not be really free and willing. Equally important, if all shareholders had that knowledge and ability, the market price might well be substantially higher than it actually is. Thus, in this respect, it is difficult to defend the paying of market price as necessarily being equitable treatment of the selling shareholder.

It has been suggested that not only should the corporation be allowed to purchase its shares when available at a price less than value, but that management has a responsibility to the corporation to take advantage of this opportunity to benefit the corporation. This position has been rejected by the Courts, who have stated clearly that the fiduciary responsibility is owed to the shareholders and not to the corporation.[46] The accepted theory of the fiduciary responsibility of the directors is that the responsibility runs equally to all shareholders. At the time a decision is made to repurchase shares, it is supposedly made for the benefit of all shareholders; at that point, the shareholder group includes those shareholders who will sell their shares to the corporation. Therefore, the fiduciary responsibility is owed to those shareholders, even though after the repurchase they will no longer be shareholders. Thus, it is incorrect to say that a corporation buys shares at a low price for the benefit of the corporation or its shareholders; it does so for the benefit of the remaining share-

holders, and at the expense of the retiring shareholders. The same duty -- to maximize stockholders welfare -- is owed to the selling as to the remaining shareholders; at that point, they are all shareholders.

This fact differentiates the reacquisition transaction from the issuing of new capital. When additional equity capital is to be issued, one part of the criteria (or in the all-equity case, the total criteria) is whether the eps will be increased by the raising and investing of that capital. In the all-equity case, if i>r, then eps will be increased, and only if that is the case will it benefit "the shareholders" to do so. Here too, all shareholders who are shareholders at the time the decision is made are included but that does not include the potential shareholders who may buy the shares. Thus, if the price is so high that i>r, and eps is thereby increased, then the "old" shareholders will have gained at the expense of the "new". But, at the time of the gain, the "new" were not shareholders, and the corporation had no fiduciary responsibility to them <u>as shareholders</u> at that time. In the case of reacquisition, the remaining shareholder group gains at the expense of those shareholders who sell, and at that time, the corporation <u>does</u> have a fiduciary responsibility to them <u>as shareholders</u>. Accordingly, the corporation's ability to improve its position or performance by reacquisition of its shares is not consistent with the traditional theory of the corporation's fiduciary responsibility to its shareholders.

The basic objection to the corporation's improving its position by reacquisition is that this amounts to benefitting the remaining shareholders at the expense of the retiring shareholders. One solution is to require that reacquisition be proportional to all shareholders. Then, if the "corporation gains" by an increase in eps or book-value, all shareholders participate equally. This effectively eliminates the objectionable aspects of this objective. However, it also demonstrates the real nature of the objective -- the benefit of one group of shareholders at the expense of another -- and it also points out the meaninglessness of total reliance on eps or book-value alone as indicators of the desirability of corporate stock reacquisition. Some clarification of this important point is required. Increasing eps as the objective of stock reacquisition does not rule out a proportional reacquisition. In such a transaction, regardless of proportionality or its absence, the eps will be increased if r>i. If it is proportional, however, the relative position of each shareholder will be unchanged, and his share of the total value of the corporation will be unchanged, <u>regardless</u> of the effect on eps. Should the distribution have been made at all? Since no shareholder has gained at the expense of another, any actual gain could come only from the decision to distribute rather than retain the funds, and <u>that</u> decision is not properly made purely on the basis of the effect on eps. There is a distinct danger in cases of non-proportional reacquisition of the transaction

appearing beneficial, when the only effect has been an inequitable redistribution of wealth among shareholders.

By the way of further explanation, assume a proportional reacquisition which would result in an increase in book-value per share. Is that increase of any significance as an indicator of the desirability of that transaction -- when a reverse-stock split would achieve the same effect, and when every dividend distribution results in a decrease in book-value? If the effect on book-value per share is used as an indicator, all dividend distributions are inferior to a reverse-split! In a non-proportional reacquisition, the only differing factor present is the potential inequity among shareholders, and the presence of that factor is undesirable.

Thus, the substantive part of reacquisition to improve the corporation's financial position is based on the inequity among shareholders. If this inequity is eliminated by proportional reacquisition, the objective becomes meaningless. Though meaningless, it may be utilized as the basis for the distribution/retention decision, for which purpose it is invalid. Accordingly, it would appear that this is an unacceptable objective of stock reacquisition.

Summary.

In any of its forms, improving the corporation's position does not appear to support the corporation's ability to repurchase its shares. The use of leverage can be achieved

without stock reacquisition, and repurchase to support the market price of its shares is generally held to be unacceptable and illegal.[47] If not proportional, repurchase to improve directly the corporation's position is inconsistent with the traditional concept of the fiduciary responsibility of the corporation to its shareholders. Even if the reacquisition is proportional, it may lead to distribution/retention decisions which are inconsistent with the accepted theory of corporate financial management.

III - The reissue of reacquired shares rather than the issue of new shares.

One objective of reacquisition is to have treasury shares available for issue and so to avoid issuing new shares in situations that require an issue of shares, but not necessarily treasury shares. The analysis that follows is focused not on the reason for the issue of shares but on the reason(s) for the issue of treasury shares rather than new shares.

Since the objective lies in the issue of the shares, the source of the treasury shares and the manner of their reacquisition is not important. Inequity among shareholders could be precluded by requiring proportional reacquisition without interfering with the attainment of the objective.

One such reason for issuing shares concerns stock-option, stock-bonus, stock-profit sharing, and employee stock-purchase plans. Corporations which enter into such plans must be prepared to issue shares on a regular and routine basis. If

no more authorized but unissued shares are available, or if the directors are unwilling to issue new shares, then the only source is already-outstanding shares, reacquired for the purpose. General Motors Corporation,[48] Standard Oil Company (New Jersey),[49] United Fruit Corp.,[50] and Warner-Lambert Pharmaceutical,[51] have used treasury stock to service stock-option plans. Such a continuous and recurrent need can be conveniently met by reacquisition of shares in the open-market on a relatively continuous basis. General Motors Corporation,[52] Standard Oil Company (New Jersey),[53] and Warner-Lambert reacquired their shares in the open market,[54] while United Fruit Corp. used open-market purchases and a tender-offer to reacquire its shares.

Another important use of treasury stock is in connection with mergers. Since this normally involves the planned use of a significant number of shares, corporations may utilize the tender-offer or accumulate shares in advance via open-market purchase and direct-purchase. Loews Theatres Inc. indicated that it was seeking acquisitions and that the company had been buying its own stock for that purpose.[55] American Cement Corp. in announcing its tender offer said the shares would be used for acquisitions and mergers, as suitable opportunities arose, although the company had no plans for acquisitions or mergers at that time.[56] Treasury shares were used in reacquisition by Warner-Lambert Pharmaceutical Company,[57] Proctor and Gamble Co.,[58] and Scott Paper Company.[59]

The use of shares in the acquisition of other corpora-

tions is encouraged by current income tax provisions regarding "tax-free mergers". Generally, the provisions operate so as to render the proceeds of distribution tax-free in the hands of the selling shareholder if the acquisition is made with shares of the purchasing corporation rather than cash.[60] This results in delaying the tax on any gain until the shares have been sold. As a result, the acquiring corporation need pay less for the shares than if cash were used because the immediate after-tax net proceeds to the shareholder are higher. Even corporations that do have cash available for acquisitions may choose to use shares instead of cash. If the cash is used to buy shares which are then used in acquisition, it amounts to a cash purchase with the benefit of the "tax-free merger" provisions.

The "tax-merger" provisions apply to the issue of all shares, whether previously unissued or treasury shares. When a corporation chooses to use treasury shares in a merger, the benefit of the tax-free merger provisions could also be achieved by the issue of previously unissued shares. In that case, the cash could be distributed to the shareholders. If the distribution were done by dividend, the total number of shares outstanding would be increased by the number issued in the merger. If the distribution were made by reacquisition of the same number of shares, the shares outstanding would have remained constant, and the tax advantage of the reacquisition method of distribution would be enjoyed. Two points should be noted:

(i) the "tax-free merger" aspects apply not only to treasury shares, but to all shares, and (ii) the tax advantage of using treasury shares is peculiar to the reacquisition transaction, not to the merger.

The use of treasury shares as stock-dividends and to meet the requirements of convertible securities and outstanding warrants stems from the corporation's unwillingness or inability to issue new shares. Burlington Industries stated at a stockholders' meeting in 1964 that the company had followed a policy of reacquiring its shares to eliminate or minimize the dilution from the impending conversion of the company's outstanding debentures.[61] Many corporations that follow a policy of regular stock dividends also follow a policy of reacquiring their shares.[62]

A. The avoidance of dilution.

Why is it attractive to reissue treasury shares, rather than issue new shares? The first reason is the desire to avoid "dilution of the equity". The discussions in the literature indicate that "dilution of equity" is not a clearly defined concept and often means nothing more than an increase in the number of shares outstanding. Some direct quotations are presented as an example of the non-rigorous thinking in this area:

> "For many of these purposes, to be sure, a company could use authorized but unissued stock. Such action, however, dilutes the equity, a step which many shareholders consider virtually a capital

crime. Clearly, using purchased stock, rather than issuing additional shares, avoids dilution and thus keeps stockholders happy."[63]

"Furthermore, use of treasury stock...avoids the dilution of shareholders' equity that would occur if new stock had to be issued for an acquisition rather than repurchased stock."[64]

"The purchase of stock to have it available for future acquisitions is a good example [of acquiring shares in order to use them later]. One of the reasons would be to forestall the dilution that would result from a new issue of shares."[65]

Finally, two comments concerning treasury stock and mergers:

"...it is our opinion that the use of treasury stock is more of a device to reduce the danger of dilution of earnings than it is a convenient medium. In fact, there is one well-known case which involved the acquisition...by Scott Paper Company of Beveridge Paper Company...Scott wanted Beveridge so badly and they were willing to pay such a high price that it would have diluted the earnings of Scott. So they issued 100,000 shares of new common and 900,000 shares of treasury stock, which they had bought in the open-market for cash, making the purchase price around 1,000,000 shares."[66]

"The advantage of using a company's own shares in acquisition...The offer of a tax-free exchange of stock without diluting the per share earnings of the acquiring company makes for an almost ideal arrangement in merger or general acquisition plans."[67]

What is a meaningful concept of dilution that can be

used in analyzing the effect of issuing treasury shares rather than new shares? Dilution can mean either:

i) the reduction of some measure of value on a per share basis, such as eps, or

ii) the reduction of some measure of value on the proportionate interest basis, such as the earnings applicable to a given shareholder's interest in the corporation.

The contrast between these two approaches is obvious in looking at the issue of a stock-dividend or a stock split.[68] Assuming a stock-split, 2 for 1 (a 100% stock dividend) this will, ceteris paribus, reduce eps by 50%. By the first definition, this has diluted the equity; by the second, it has not. The second approach would appear to be the more meaningful, and is in accordance with the concepts of the maximization of the shareholder's interest, which is an integral part of the theory of corporate financial management. There is no substantive change in the equity of a shareholder by virtue of a stock-dividend; the same amount of assets and earnings are divided among the same people in the same way, and the proportionate interest of each shareholder in the corporation is unchanged.

In discussing the effect of using treasury shares rather than new shares, the existence of two separate and distinct transactions must be recognized. The first is the reacquisition transaction which focuses on the price paid for the reacquired shares. The second is the reissue transaction which

focuses on the relationship between the number of shares issued and the assets received in return. Only the first transaction -- discussed in Chapter III -- is peculiar to the use of treasury shares. However, the criticism of the common usage of the term "dilution" requires that the second transaction be considered briefly.

Any distinction between the issue of new shares and the issue of treasury shares made on the basis of the "dilution" effect is questionable. There is nothing peculiar, in an economic sense, about the reissue of treasury shares, and the determining effect of the relationship between the number of shares issued and the assets received in return will be unaffected by the use of treasury shares, whether it be a merger, stock-option, stock dividend, or any other use. In the acquisition of another corporation by the issue of shares, the price paid may be "high" or "low" but the attractiveness of the price is unaffected by whether the shares issued are new or treasury.

What is the effect, in terms of dilution, of using treasury shares rather than unissued shares? As a first example, the stock dividend case will be used:

Assume a corporation such that

Assets	$1,000	Equity	$1,000
-rates of earnings on assets, 10% total earnings $100 eps = $ .10.		(Shares outstanding, 1,000)	

If the corporation pays a stock dividend of 10% by the issue of 100 new shares, the result will be:

Assets	$1,000	Equity	$1,000
-total earnings $100; eps = $ .0909 (rounded)		(Shares outstanding, $1,100)	

A shareholder who originally held a 10% interest -- represented by 100 shares -- now holds 110 shares, in each case 10% of the total shares. The earnings attached to his interest was 100 shares times $ .10 or $10.00; it now is 110 shares times $.0909 or $10.00 (rounded). However, the eps has been "diluted" from $ .10 to $.0909.

If treasury shares are used "to avoid dilution", what occurs? Assume that the $100 is used to purchase 100 shares to pay the dividend. At that point,

Assets	$900	Equity	$900
		(Shares outstanding, 900)	

Now, the stock dividend is issued, the 100 shares distributed:

Assets	$900	Equity	$900
		(Shares outstanding, 1,000)	

If it is assumed that the rate of earnings on the assets distributed was zero, then the total earnings will remain at $100, eps will remain at $ .10 and dilution has been avoided. However, all that has really been accomplished is to keep the total number of shares outstanding at a constant number. The amount

of assets is reduced, and only by assuming either (i) zero earnings on the assets distributed or (ii) that the cost of the reacquired shares is zero, are the eps kept constant. Too often, as exhibited by the quotations, one of these two assumptions is implicitly made. For example, if above, the return on the distributed assets was 5% (rather than zero), then the total earnings after the reacquisition would have been only $95, and eps would have dropped to $ .095. To assume that the use of treasury shares will prevent dilution is to ignore the fact that the reacquisition involves a distribution of assets and some attendant reduction in the potential earnings of the corporation. Deliberately reacquired shares are normally not free.

When share reacquisition is being considered, it must be recognized that the complete alternatives are these:

(1) retain all the assets, maximize earnings thereon, and issue additional shares, or

(2) distribute a certain amount of assets, have a smaller amount of assets to generate earnings, but keep the shares at the same number.

The issue of additional shares does not necessarily cause dilution of the shareholder's interest, although the eps may be relatively less under that alternative. However, it must also be recognized that the issue of additional shares need not cause a decline in eps. If the assets received can be employed to

generate enough earnings to at least equal the eps on the already outstanding common shares, then the eps will not be decreased. This is true of any decision concerning the issue for consideration of additional equity capital, regardless of the source of the shares issued. This applies equally where shares are issued in connection with a merger. In such cases, the alternatives are:

(1) retain all the present assets, acquire new earning assets, but issue additional shares therefore, or

(2) distribute a "certain amount" of assets, acquire new earning assets, but keep the number of shares outstanding constant.

Here the considerations and conclusions of Chapter III are applicable. For the given number of shares, that "certain amount" of assets will be determined by the price paid per share, and the effect on eps will be determined by the price paid per share and the rate of earnings on the assets distributed.

Admittedly, the speakers quoted above are probably viewing the total transaction of "reacquiring-and-issuing-in-acquisition" as opposed to "not-reacquiring-at-all". Even then, the only thing that necessarily follows is that the number of shares is increased unless treasury shares are used. Whether dilution will occur is a function of both aforementioned transactions. Conceptually, the non-cash acquisition for which

the shares are issued could be a "bad" one, in that the price was too high -- too many shares were given for what was received. Still, this bad deal might be offset by the favorable effect of the reacquisition. As discussed in Chapter III, the price paid per share might have been so "low", and the rate of earnings available on the distributed assets (had they been retained) so "low" that the corporation's eps was increased by the reacquisition of the shares (as opposed to not reacquiring). Thus, this favorable effect might partially or wholly offset the effect of a "bad" acquisition.

The significant point is that the effect of the use of treasury shares rather than new shares is found in the reacquisition transaction, and not in the reissue transaction. This applies to all cases of reissue of treasury shares, but the merger case will be used as an example because it demonstrates both transactions. Assume the following corporation before entering into a transaction to acquire the assets of another corporation:

Assets	$1,000,000	Equity	$1,000,000
-earnings @ 10% =	$ 100,000	-shares outstanding	100,000
-eps = $1.00			

Assume that the total assets of a corporation with expected future earnings of $8,000 per year can be acquired for 9,000 shares. The effect on eps will be negative, since the terms are such that the eps from the new assets alone is $\frac{\$8,000}{9,000}$ or less

than $1.00. This will therefore draw down the eps on all shares. Assuming that new shares are issued in acquisition, the result would be:

$$\frac{\text{Total earnings}}{\text{Shares outstanding}} = \frac{\$100,000 + 8,000}{100,000 + 9,000} = \frac{108,000}{109,000} = \text{eps of } \$ .99$$

Now assume that reacquired shares are to be issued instead of new shares. Therefore, the firm must acquire 9,000 shares. If the price of the shares in the market is $8,000, then the repurchase will cost 9,000 x $8.00 = $72,000, and the firm's earnings will be reduced by 10% thereof, or $7,200.[69] Now, the effect of reacquisition alone on eps will be favorable, because i, the rate of earnings, is 10%, while r,(the earnings/price ratio), is 12 1/2%.[70] The eps after can be calculated as:

$$\frac{E - Di}{S - Dr\left(\frac{S}{E}\right)} = \frac{100,000 - (72,000)(.10)}{100,000 - (72,000)(.125)\left(\frac{100,000}{100,000}\right)}$$

$$= \frac{100,000 - 7,200}{100,000 - 9,000}$$

$$= \frac{92,800}{91,000}$$

$$= \$1.01978$$

Now, given the effect of both transactions, the resulting eps will be:

$$\frac{\text{Total earnings} = 100,000 + 8,000 - 7,200}{\text{Shares outstanding is unchanged}} = \frac{100,800}{100,000} =$$

eps of $1.008, significant because it is greater than $1.00.

While the merger did dilute the equity, the total transaction did not, because the reacquisition was made at so low a price that r>i.[71] The resulting eps of the various alternatives should be noted:

(1) no reacquisition, no merger	$1.00
(2) no reacquisition, merger	$ .99
(3) reacquisition, no merger	$1.02

The optimizing move was to reacquire, but not merge, which is an objective in itself, discussed above.

What about the situation where the corporation has redundant cash but needs shares to issue? The corporation can either distribute the cash as a dividend and issue new shares, or it can use the cash to reacquire shares for reissue. In terms of the dilution effect on the total stockholder group, there is no difference between the two methods of carrying out the transaction. However, unless the reacquisition is proportional, the price paid for the shares may be such as to result in inequity among individual shareholders, a situation that does not apply with a dividend distribution. The tax advantage of reacquisition over a dividend distribution might apply, but the validity of such tax-avoidance as the objective of reacquisition has been discussed above.

The "avoidance of dilution" is not a meaningful objective for the reacquisition of stock, since in that respect, there is no substantive difference between the issue of treasury

shares or new shares.

B. Legal and regulatory factors.

It is conceivable that legal or regulatory factors might make the reissue of treasury shares more attractive than the issue of new shares. This is not true in respect to securities regulation, since treasury shares are subject to the same registration requirements as unissued shares,[72] regardless of whether the shares are to be resold for cash or reissued in connection with stock-plans or acquisitions.[73]

In respect to the pre-emptive right, the difference between treasury shares and unissued shares is not necessarily a significant factor. While the pre-emptive right does not apply to the reissue of treasury shares,[74] it does not necessarily apply to the issue of new shares. The pre-emptive right is generally held not to apply to new shares issued for property (non-cash) or in the case of merger or consolidation.[75] In respect to employee stock-plans, most jurisdictions provide for the sale of shares to employees free from otherwise-applicable pre-emptive rights when approved by a two-thirds majority.[76] Most jurisdictions, expressly or by implication, authorize the articles of incorporation to deny or limit pre-emptive rights.[77] If the articles originally include the pre-emptive right, they may be amended to exclude it.[78] Generally, the proposed amendment must be submitted to a vote of the shareholders, and approved by a two-thirds vote of the common share-

holders.[79]

In general, the effect of this situation on the use of treasury shares is as follows: In many cases, the pre-emptive right does not apply to the issue of new shares, and in those cases there is no advantage to using treasury shares. Where the pre-emptive right does apply to the issue of new shares, three alternatives are available: comply with the pre-emptive right, render the right inapplicable, or issue treasury shares. When viewed in this way, the use of treasury shares is a means to avoid compliance with the pre-emptive right. If the right is ordinarily applicable to an issue of shares for the particular purpose at hand, should it be avoidable by the issue of treasury shares? If it is held acceptable that the pre-emptive right be avoided, the mechanism for rendering it legally inapplicable is generally available to the corporation -- shareholder approval for amendment of the charter. Viewed in this way, the use of treasury shares is a means of avoiding the process of getting formal shareholder approval of the inapplicability of the pre-emptive right. Accordingly, the use of treasury shares can be construed as a means of avoiding either an otherwise-applicable pre-emptive right or the need for shareholder approval to do so. This is not a desirable objective of stock reacquisition.

A corporation might be forced to reacquire shares for reissue because it has no more authorized but unissued shares. To be able to issue more shares would require a formal increase

of authorized capital which may be considered onerous and involved by corporate management. The authorized capital, including the number of shares, is part of the original articles of incorporation, and to have it increased involves essentially the same procedure as discussed above with respect to preemptive rights.[80] The corporation can (when drafting its charter or when increasing authorized capital) authorize enough shares for the foreseeable future. Since the procedure for increasing authorized capital would not appear overly onerous, the absence of authorized but unissued shares should not be a strong reason for the use of treasury shares. However, management may find it onerous or difficult to convince shareholders of the need for additional authorize capital. "...mechanically, it is often easier to reissue treasury shares than to issue new shares. The issuance of new shares often requires that additional stock be authorized by a stockholder vote, a matter which can be annoying at best and difficult at worst."[81] The use of treasury shares is simpler, since the directors can do this on their own initiative without the bother and delay of submitting the amendment to the shareholders at a formal meeting. Again, the ability to avoid shareholder approval that would otherwise be required is not an acceptable reason for the use of reacquired shares. If shareholder approval is desirable, then management should not be able to avoid it in this way. If shareholder approval is unnecessary, then the statutes should be changed appropriately.

Summary.

The reasons for the issue of treasury shares rather than new shares are subject to question. The use of treasury shares may prevent the total number of shares outstanding from increasing, but it does not, in any meaningful sense, prevent the "dilution of equity" attached to the issue of shares. The avoidance of the pre-emptive right or of the need for shareholder approval, of either the inapplicability of the right or of an increase in authorized capital, does not appear to be acceptable objectives for a corporate transaction.

Nevertheless, the reacquisition transaction appears to be well established, and this should not be ignored in formulating public regulation. Corporate management may find the use of treasury shares to fill recurrent committments a considerable convenience, and it does cater to their unwillingness to increase the number of shares outstanding. The problem of inequity could be solved by requiring that all reacquisitions be made on a pro rata basis, and the question of the pre-emptive right could be solved by eliminating any effective difference between unissued and treasury shares. However, there is a certain hesitance involved in allowing a transaction to continue when the incentive to its use is based on a misunderstanding of its effects. On the other hand, a parallel situation already exists in the financial world in the concept of the "value" of the stock dividend.

IV - Reacquisition for the benefit of controlling shareholders.

The distinguishing characteristic of these cases is that reacquisition is carried out for the benefit of the controlling shareholders, rather than the benefit of the corporation or of all shareholders. The basis of such transactions is the power of the controlling group to require the corporation to repurchase its shares at such time and in such manner (including the selection of shares to be purchased) as the group decides.[82] This power, coupled with the directors' "insider" knowledge, are the essential components of such transactions.

The benefit to the controlling group may take any of three forms. The controlling shareholders may recognize that the price at which the shares are available is less than the value of the shares, and have the corporation reacquire shares from minority shareholders. Here deliberate advantage is taken of the potential inequity connected with reacquisition per se. Alternately, the benefit may derive from the effect of reacquisition on the voting aspects of the control position. Finally, a corporation may reacquire the shares of a major shareholder simply to aid him in reducing his shareholdings.

A. Reacquisition to benefit the controlling interest.

The controlling group may be of the opinion that the value of the shares is greater than the price which would have to be paid to buy them. The value of the controlling groups'

shares will be increased if the corporation repurchases shares and the group sells none of its shares. To the extent that the corporation reacquires shares, (and to an extent determined by the relevant variables as demonstrated in Chapter III), all remaining shareholders will benefit, the controlling group among them.[83]

This objective is subject to criticism on the grounds that the majority shareholders are conducting the affairs of the corporation for their own benefit rather than for the benefit of all shareholders. Aided by their "insiders'" knowledge of corporate affairs which gives them an advantage in assessing the value of the shares, they utilize deliberately the inequity involved in reacquisition.

An alternative method is to have the corporation purchase shares in the open market to drive up the price. When the price has increased sufficiently, the controlling group can either sell shares in the market at the higher price or force the corporation to purchase their shares at that price.[84] Here corporate assets are being utilized -- distributed -- for the benefit of the controlling shareholders, rather than of all shareholders.

B. Reacquisition to strengthen the voting position of the controlling shareholders.

The desired effect is the reduction in the number of shares outstanding, thereby increasing the proportionate significance of a given holding of shares. The corporation is made

to repurchase shares and the controlling shareholders refrain from selling any of their shares. The number of outstanding shares that must be reacquired by the corporation to make a given number of shares represent a controlling interest -- or any desired percentage -- can be readily calculated by the use of the formula presented in Appendix IV. In general, to achieve a desired change in significance of a given number of shares, more shares would have to be repurchased by the corporation than by the shareholders themselves. However, when the corporation purchases the shares, the shareholders themselves need not furnish the funds, since corporate funds are used.

There are two distinct situations where this objective is applicable. Where a group exercises effective control of a corporation, but holds less than 50% of the outstanding shares, the group may wish to strengthen its position by increasing the voting percentage or by bringing it up to 50%.

The second situation would not be expected to occur often in the case of the publicly-held corporation, but is not irrelevant. The controlling group may control 50% or more of the shares, but may wish to strengthen its position sufficiently to guarantee shareholder approval of an extraordinary corporate transaction. Matters such as mergers, liquidations, or a change in the corporation's charter normally require the approval of two-thirds or three-quarters of the shares outstanding and the controlling shareholders may wish to eliminate the risk of having such a transaction blocked by the minority shareholders.[85]

This too is a case of using corporate assets for the benefit of the controlling shareholders. (Repurchase to protect the control position for the benefit of the corporation is discussed below.) The strengthening of the control position could be achieved by the purchase of shares by the controlling group (with their own funds), which would also eliminate the problem of inequity which may accompany the repurchase transaction.

C. To allow a major shareholder to reduce his holdings.

The corporation purchases the shares of a particular shareholder to aid him in disposing of his shares. In the publicly-held corporation, this normally occurs only when that shareholder is in a controlling position. This was the case when the majority holdings in Hilton Hotels Corp. were to be reduced by Court Order. Management facilitated this by having the corporation reacquire the shares from the majority group.[86] All-State Bowling Centres Inc. sought tenders to purchase the shares of All-State Properties, its major shareholder.[87] All-State Bowling Centres Inc. sought up to 200,000 shares (out of 400,000 outstanding). The major holder held 147,000 shares and intended to offer all of the shares.

Insofar as this is done solely for the benefit of the selling shareholder, this amounts to the use of corporate assets for the benefit of the controlling shareholders. However, it may be to the benefit of all shareholders to assist the shareholder in disposing of his holdings, in that an ordinary sale of shares in the open-market might have a depressing effect on the share

price. As such, this objective does not require that the corporation acquire the shares; unless the corporation needs the shares, it would have to eventually dispose of them, with the same problem of the effect on the market price. The corporation can assist in the disposition of such a controlling block by aiding the shareholder in a secondary distribution to the public. This would not involve repurchase, thereby avoiding the problems of inequity among shareholders. It would also avoid the use of corporate funds during the period between repurchase and resale. Should the shares in fact not be sold at the expected price, but at a lower price, the loss would fall to the shareholder, rather than the corporation, which is appropriate.

In general, the publicly-held corporation has no responsibility, or right, to indemnify a shareholder against loss on the disposal of his shares. Accordingly, the corporation has no right to use corporate assets, at the expense of the other shareholders, for the benefit of only the selling shareholder. Insofar as the assistance is for the benefit of the remaining shareholders, the corporation's assistance may be valid. However, that assistance can be extended without the reacquisition of shares and without the problem of inequity among shareholders.

D. Summary.

These objectives of reacquisition have in common the use of corporate assets for the benefit of the controlling group

of shareholders, rather than of all shareholders. This is unacceptable from both the point of the objective of corporate management -- to benefit equally all shareholders -- as well as from the point of view of the fiduciary responsibility of the majority shareholders to the minority shareholders. There are benefits which may accrue to all shareholders, but they can be achieved by other means which are readily available and which do not involve the problem of inequity associated with reacquisition.

V - Reacquisition to defeat the threat posed by the corporate "raider".

The objective of repurchase is to prevent the controlling group from being replaced by an outside group seeking to gain the control position -- the outside group traditionally referred to as corporate "raiders". This may be accomplished either by purchasing the shares of the raider or by purchasing the shares of other shareholders. In the former case, the threat is eliminated directly as the raider ceases to be a shareholder. In the latter case, the purchase increases the voting significance of the controlling group's shares and also makes the repurchased shares unavailable to be voted by the raiders.

Such repurchases, which involve the use of corporate assets for the express purpose of protecting the position of the incumbent controlling group, are justified as beneficial to corporation and its shareholders, rather than simply to protect the controlling interest. Supposedly the outsiders -- the raiders --

would have followed policies detrimental to the corporation, and they must therefore be kept from gaining control.

This objective raises two questions. Is the repurchase really made to protect the corporation against the raider, or is it made simply to maintain the control position of the incumbents? More fundamental, is the protection of the control function, no matter how good the reason for doing so, an appropriate objective of stock repurchase?

Where those in control of a corporation have used corporate funds for the purpose simply of perpetuating their own control, the Court has found the users liable to the corporation for breach of fiduciary duty.[88] However, when the purpose is to protect the corporation from the detrimental policies of an outsider, the situation changes. In general, if a purchase is made by management in the exercise of honest business judgment, to eliminate what appears to be a clear threat to the future of the corporation, it is considered a legitimate business transaction and there is no liability for using corporate funds to suppress the threat.[89]

In practice, the question is whether the intent was to protect the controlling position or to protect the corporation against a raider. Even though the intent is the former, it can usually be claimed to be the latter. For this reason, Courts require evidence that the controlling group had a reasonable basis for believing that the intended actions of the outsiders would be either harmful and/or unlawful.[90] In theory, the

Court must be satisfied that the outsider did intend a different policy, that his policy would have led to a corporate detriment, and that the controlling group had, on the basis of adequate investigation, reason to believe that this was the case. In practice, however, the Courts have placed their emphasis on the exercise of due care by management in determining whether the outsiders' policies posed a threat to the welfare of the corporation; if care is apparent, and a "threat" -- the existence of a rival -- is present, then the purchase is legitimate as being based on business judgment.[91] Little if any consideration is given to the question of which policies would have been better; management's word is generally accepted that their own policy was best. Thus, the Courts' decision is made largely on the basis of the controlling group's word that the repurchase was justified. "Although the courts' opinions occasionally purport to deny it, their decisions suggest that they have placed on the challengers [those bringing suit against the insiders for use of corporate assets to protect the control position] the burden of establishing the primacy of the self-serving purpose rather than requiring the insiders to negate such a purpose."[92]

Repurchase for this purpose is open to serious question. In practice, the true intent of the controlling group is difficult to determine, and the transaction is open to abuse as a means of protecting the control position for the benefit of the controlling group. Whenever a rival group is present, it can be

expected that their policies will be different and management may attempt to hide behind the claims of a "threat to the corporation". This is facilitated by the Courts' willingness to look only to the due care exercised in the decision and its unwillingness to try to determine whether the outsiders' policies would, in fact, have been better or worse for the corporation.[93] One writer speaks most strongly of the Courts' willingness to accept the position of the controlling group:

> "...[The Courts' opinions] are grounded on the assumption that it is proper for management, and ultimately the Courts, to decide in advance that outsiders will gain control and that the activities contemplated by them will be so harmful from a business standpoint or of such questionable legality as to justify both the economic cost of thwarting their attempt (...the expenditure of corporate funds) and the denial to the stockholders of the opportunity to vote on whether they would authorize outsiders to undertake such activities. However, it is one thing to conclude on the basis of the actual conduct of corporate affairs and demonstrated economic results that those in charge have illegally milked the corporation ...or managed the enterprise unsuccessfully or inefficiently. It is quite another thing to form such a conslusion on the basis of predictions by interested witnesses as to what policies outsiders will follow if they get control, and to decide that other possible uses of corporate funds are less desirable than their use to prevent the acquisition of control by persons who may commit acts which may be unlawful or economically disadvantageous if they acquire control."[94]

The most significant question is whether the incumbent group should be allowed to use repurchase to defeat the outsiders' threats to control. The control position should be protected against those whose policies would have a detrimental effect on the corporation, and the incumbent group have a duty

to attempt to do so. However, the repurchase of stock is not the only means available for this purpose, and the alternative means, the proxy contest, is readily available. The ability to repurchase shares in these cases constitutes an ability on the part of the incumbents to avoid a proxy contest. As expressed by one writer:

> "By allowing corporate officers or directors to purchase the corporation's shares in the exercise of their honest business judgment the Court has allowed further dilution of the vote of the franchised corporate shareholders. By allowing management to silence the voice of the raider in this fashion, the Court has been a party to making it possible for the incumbents to tighten their control, while never having to brace the dangers of a proxy fight. Instead of having to justify their policies to their shareholders, instead of allowing the shareholders to choose what they feel would be for the best interests of the corporation, instead of having to answer their insurgent critics' charges, management is allowed to by-pass the electoral arena and hide under the umbrella of 'honest business judgement'."[95]

The proxy contest may be a better method of dealing with the control question than is stock repurchase. The proxy contest uses corporate assets to protect the incumbent group, but uses them to inform the shareholders and to encourage them to participate by exercising their franchise. In repurchasing, however, corporate assets are used to eliminate the possibility of the shareholders' rejecting the incumbent group. In a proxy contest, the disclosure involved should result in an examination of the policies and performance of the incumbent group as well as of the "raiders".

In a proxy contest, the corporation incurs only the costs involved in the contest, whereas the repurchase of shares may involve a considerable shrinking of the corporation (and a weakening of its position and capabilities) when assets are distributed, or a change in the financial structure if debts are incurred to finance the repurchase. Too, repurchase is limited by the surplus rule where the costs of a proxy contest are not.

Repurchases for this purpose are necessarily other than pro rata and inequity among shareholders may result. If the shares are purchased from the raiders, the price may be so high as to involve a detriment to the remaining shareholders. Of course, the value of avoiding the raiders' policies may be such as to outweigh this premium paid, and "everyone gains". However, this is not necessarily a strong point in view of the existence of the proxy contest alternative.

Basically, the whole concept of one-share-one-vote is undermined when one group can alter the significance of each of those votes, as the controlling group can do by repurchase. The ability of the controlling group to increase their voting power by repurchase is contrary to the basic assumption underlying the stockholders' right to vote -- that they have the power to determine who is to manage corporate operations for the benefit of the shareholders. In theory, insiders may be better able to assess the circumstances and decide whether the raiders' policies are detrimental. In practice, however, it is rather naive

to expect a controlling group to passively give up their position when legal means to prevent it are available.

Share repurchase allows the controlling group to perpetuate its position and eliminate the possibility of losing that position in a proxy contest. This amounts to making the corporation an "island unto itself", with the corporation, and the determination of its control, completely isolated from shareholders.

There are obviously problems involved in the use of share repurchase to protect corporate control. The basic problem of the potential inequity among shareholders cannot be eliminated by the use of proportional reacquisition, for the repurchase must be other than pro rata. The problem would be eliminated by prohibiting repurchase, which may be feasible since the alternative of the proxy contest is available. This would also eliminate the problem of the protection of the controlling position for the benefit of the controlling group. The use of the proxy contest would preserve the shareholders' right to choose the controlling group, in what may be the only circumstance where the right is significant.

Alternately, repurchase could be allowed, but only on the prior approval of the majority of the shareholders. While this has been suggested, it does not appear to be a satisfactory or practical solution. The problem of inequity among shareholders is not eliminated, even though the price to be paid might be subject to approval by the shareholders, A more basic

practical point is that the requirement of shareholder approval could be expected to involve generally the same procedure as a proxy contest, which would favor using the contest instead.

As a practical matter, if a market purchase program is planned to frustrate the outsider, advance authorization from the shareholders is likely to be self-defeating by informing outsiders and shareholders and driving up the price. If stockholder approval is sought before buying out the potential raider, then this is immaterial, because management and the raider will presumably have agreed on a price, a process necessary to ensure shareholder approval. If the shareholders should refuse to authorize the repurchase, then the proxy contest would still be necessary. Repurchase on the prior approval of the stockholders is not a practical solution to the problem.

Summary.

Reacquisition to defeat the threat posed by the corporate raider involves significant problems as well as attractive aspects. As all reacquisitions which are other than proportional, it poses the problem of inequity among shareholders. It presents the opportunity for the controlling group to protect its own interests and undermines the one-share-one-vote basis of corporate control. However, it provides the corporation with a useful means of protecting itself, and the interests of its shareholders against the detrimental effects of the "raider". The existence of the ability to reacquire shares for this pur-

pose provides the means for the controlling group to avoid a confrontation with the rivals and shareholders; the proxy contest -- an established procedure -- provides an alternate means of settling the issue by putting the issue before the shareholders. Theoretically at least, the proxy contest makes reacquisition for this purpose unnecessary, and the undesirable aspects of non-proportional reacquisition may render it objectionable.

VI - Repurchase of shares to eliminate dissenting minority shareholders.

Sometimes the objective of a repurchase of shares is to eliminate disputes between a corporation and its shareholders, or to eliminate opposition by shareholders to some proposed corporate action. Shareholders who disagree with proposed corporate actions may delay them by voting against them or may force management to actively solicit proxies to ensure shareholder approval of proposed actions. Shareholder disputes may also involve the corporation as a defendant in a shareholders' or a derivative suit. Under some circumstances, such opposition and proceedings could be detrimental to the corporation as a whole. If so, the directors may decide to eliminate the difficulty by repurchasing the shares involved. The Courts have upheld a repurchase of shares by a corporation in settlement of such disputes.

A basic problem in such transactions is the price paid for the shares. The price may be substantially in excess of the

value of the shares, since it includes an amount in settlement of the dispute. Management may be willing to pay substantial amounts of the corporation's assets in its desire to rid itself of the difficulty. Transactions for this purpose are generally carried out on the initiative and authority of the directors, without shareholder approval.

A. Shareholder and derivative suits.

Shareholders who question the legitimacy of corporate actions may bring a shareholder or derivative suit against the corporation. Legal proceedings, even when they end in favor of the corporation, are involved, lengthy and expensive, and may result in bad publicity for the corporation. The value of disposing of the action may justify a substantial settlement, and the directors' ability to quickly dispose of the claim may benefit the corporation and its shareholders.

A shareholder may sue the corporation (in his own right and for his own benefit) where wrongful acts by directors have resulted in direct injuries to him.[96] The derivative suit, on the other hand, is an action brought by a shareholder on behalf of the corporation, to enforce a corporate right against the directors on account of wrongful acts which injured the corporation. It is intended to give minority shareholders a "procedural device designed to facilitate holding wrong doing directors and majority shareholders to account..."[97] The following excerpt from the Court's statement presents the philosophy and develop-

ment of the derivative suit:

> "As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust. The business code became all too tolerant of such practices. Corporate laws were lax and were not self-enforcing, and stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust.
>
> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own...This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses."[98]

The Court recognized the abuses that existed in the form of the corporation's ability to buy-off these suits, and the strike-suits that resulted from the corporation's ability and willingness to do so.

> "Unfortunately, the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any

> wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as '<u>strike suits</u>'. And it was said that these suits were more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest was more often within the capacity and readiness of management to compromise than a large one."[99]

A corporation's ability to repurchase shares in such cases may allow directors to escape the scrutiny of the shareholders and/or courts. If the shareholder does not have a legitimate claim -- a legally enforceable one -- then it should not be settled out of Court. If the claim is legitimate, then the corporation and directors should not be able to avoid the disclosure involved in a legal suit. Most especially, the directors should not be able to do so by using the corporation's assets to "buy-off" the shareholder. In the case of the publicly-held corporation, it is difficult to justify the corporation's ability to conceal from its shareholders an action brought against management or the corporation by a shareholder, or to conceal the terms of settlement with such a shareholder. Stock repurchase allows this to happen.

Obviously, management should be able to rid itself quickly of "nuisance" suits that involve a disproportionate amount of bad publicity. On the other hand, legitimate claims are the ones most likely to involve the most damaging publicity. The problem is how to retain the former with doing away with the latter. In

any case, the ability to repurchase shares is not essential to the settlement of a claim since the desired effect is not the possession of the shares by the corporation but the settlement of the suit. If it is desirable that a means of quick settlement be available to management, then the power should be given to management -- to the extent that it is not already available -- to carry out such a transaction without stock repurchase.

It must be recognized, however, that a repurchase of the shares is a convenient method of making the settlement and getting the shares out of the hands of the shareholders. (If a legal action has been started, this now makes the corporation the plaintiff as well as the defendant.) The problems involved could be solved by requiring prior shareholder approval of a repurchase and the price to be paid. If the transaction is to benefit shareholders, let them decide on its legitimacy. This would slow down the process, however, as would a requirement of the Court's approval of any settlement. A reasonable alternative might be to require disclosure to the shareholders of the circumstances and terms of the settlement after the transaction. Then, if the shareholders felt that it was not a legitimate transaction, they could bring a derivative suit against management.

On the grounds that such transactions are for the benefit of the corporation and its shareholder, it does not seem reasonable to have such purchases limited by the "surplus rule" -- if a purchase is desirable and necessary, the absence of

surplus does not alter the fact.

It would be appropriate to allow the repurchase for this purpose, but in a more regulated form. As it now exists, repurchase allows management to eliminate legitimate claims and avoid scrutiny of their actions, by a means that they initiate and carry out on their own authority, without having to report the matter to the shareholders. The situation is significantly improved by requiring prior shareholder approval or disclosure of full details to the shareholders after the fact.

B. Appraisal remedy provisions.

A corporation may also repurchase its shares under the "appraisal remedy" provisions of the corporation statutes. This procedure is intended to enable minority shareholders who object to certain extraordinary corporate transactions to require the corporations to buy their shares, thereby allowing them to withdraw from the corporation.[100] The intent of the appraisal remedy is two-fold: to allow a majority of the shareholders to make fundamental changes in the corporation and, at the same time, to give a dissenting minority shareholder an opportunity to withdraw from the corporation.[101] The appraisal remedy is well established. West Virginia is the only state that does not provide an appraisal right in its statute.[102] Furthermore, in most statutes,[103] including the Model Act, there is no restriction other than insolvency on the funds available to a corporation for the purchase of shares in accordance with the appraisal

provision.[104] There is no evidence that the recognition of the minority shareholders' right of dissent is considered undesirable or objectionable by legal writers or the Courts. It is reasonable to deal with that right by requiring the corporation to repurchase the dissenting shares. Presumably, the number of shares to be purchased would be limited, since the extraordinary transactions must be approved by at least a majority (usually two-thirds of the vote). Such reacquisitions should not be restricted to surplus since the occasion for such repurchase might occur where surplus is not available -- i.e., reorganization. Such transactions are not on the initiative of the corporation, usually require the appointment of an appraisal committee, and there is normally statutory provision for the method of determination of the value of the dissenting shares. Given the nature of the transaction, the circumstances under which it might occur, and the statutory regulation thereof, a corporation's ability to reacquire its shares for this purpose is both acceptable and desirable.

VII - Miscellaneous objectives.

Included here are objectives that have not been specifically considered above and that are generally of minor significance.

A. Objectives involving the trading in shares.

By trading is meant the buying and reselling of shares

in the market. Those objectives achieved by the trading in shares are currently of minor practical significance because Federal securities law makes dealing in its own shares onerous for a corporation and renders unfeasible any program of regular repurchases and sales.[105] Dealing in its own shares is onerous for a corporation for several reasons. The resale of treasury shares by a corporation is subject to the same requirements as would be an issue of new shares,[106] and a corporation is required under Section 5 of the 1933 Act to file a registration statement, or what is considered equally burdensome,[107] the notification required for a "small issue". Registration is considered an expensive and time-consuming process,[108] which would have to be done regularly if shares were to be resold regularly. This registration requirement also removes the possibility of anonymity on the part of a corporation.

(1) Treasury stock as a short-term investment.

Why would corporations want to purchase their own shares as "marketable securities" -- a short-term investment of idle funds? The corporation is supposedly able to make a more informed assessment of its own shares than of the shares of other corporations. The return expected includes both the possibility of a gain on the eventual resale and the dividend payments avoided while the shares are held. The gain on resale is tax exempt and the "dividend-saved" is tax-free "income". However, treasury shares have several distinct disadvantages as short-term invest-

ments when compared to securities of other corporations. A corporation must exercise some degree of care in its actual repurchase of shares to avoid having a manipulative effect on the price of shares. It must also exercise care in its disclosure activities to avoid the potential problems in connection with Rule 10b-5 discussed in Chapter IV. Too, the resale of treasury shares is subject to registration with the SEC whereas the sale of shares of other corporations is not.

While the investment of idle funds by a corporation is an acceptable objective, other avenues for short-term investment are readily available. The objective of investment of idle funds is achievable without the potential inequity involved in reacquisition simply by purchasing other marketable securities.

(2) Trading in shares to affect the market price thereof.

A distinction must be made between purchases to support the market in connection with an issue of shares and purchases made as part of a plan to manipulate the market price of a corporation's shares. Actions intended to artificially affect the market price of a share are generally prohibited on the grounds that "it is of the essence of the economic functions of a securities exchange that it is a free market".[109] However, certain limited purchases to stabilize the market in connection with a new issue of shares are allowed under federal securities law.[110] Stabilization has been described by the Commission as

"that process whereby the market price of a security is fixed or pegged for the limited purpose of preventing or retarding a decline in contemplation of, or during, a public offering of securities".[111]

It is not necessary for the corporation itself to carry out the stabilization activity, as arrangements can be made to have an underwriter assume responsibility for that activity. This is advantageous, because an underwriter need not register the subsequent resale of the shares while stabilizing the market. The corporation would have to register or find some exemption for the resale of any shares repurchased.[112] Market-stabilization in connection with an issue of shares is an acceptable objective, but it can be attained without the corporation's ability to repurchase its own shares.

With the exception of stabilization activity, purchases of securities for the purpose of creating an artificial market are prohibited under federal securities law. Section 9 of the Securities Exchange Act outlaws a series of specific manipulative practices, and Sec. 9(a)(2) provides that it is unlawful "to effect...a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others".[113]

While manipulative practices have been made illegal, they have not been eliminated. Sidney Robbins, in 1965, after

having participated in the Special Study of the Securities Markets, said,

> "Manipulation as historically practiced...has been largely eliminated by the Securities Acts. The ingredients leading to manipulation...remain, however, and it would be naive to assume that efforts to influence prices for personal gain have been eliminated. The difference is that...such efforts still exist in new and sometimes more subtle forms."[114]

This is potentially, if not actually, true of the use of corporate stock reacquisitions. The corporation may reacquire shares to drive up the price for the corporation's gain. This was supposed to have occurred in the Genesco case, where the Commission alleged that the Company had used stock purchases by a company-controlled stock-purchase plan to drive up the market value of the company's shares. This allowed the company to make acquisitions of other corporations at what amounted to bargain prices. Genesco had disclosed that over a four-year period, while issuing more than one million shares in 12 acquisitions, it had directly accounted for as much as 75% of the trading in its own common stock on the New York Stock Exchange.[115] The Commission felt that purchases of a company's shares by pension funds, trusts, stock-option plans or employee payroll-deduction arrangements present manipulation opportunities so long as the buying is directed by company officials.[116]

Alternately, repurchase may be intended to drive up the price for the benefit of controlling shareholders. This seems to have been the situation in respect to Merritt-Chapman and Scott in 1964. The company announced an offer to purchase shares at a

price of $19 a share via a tender offer. Louis E. Wolfson, chairman and controlling stockholder, announced in the letter to the shareholders that he and associates might sell as many as 400,000 shares.[117] Also disclosed, and of interest here, is that the company had been purchasing its own shares since 1961, at times accounting for 90% of all market activity in the stock. During that period, the share price had gone from $11.625 per share to over $18.00 per share. The controlling shareholders were in a position to have benefitted by virtue of those reacquisitions.

The reacquisition and resale of shares for the purpose of price manipulation is contrary to the operation of a free and orderly market for securities, and is not included in the legitimate objectives of corporate management. As such, price manipulation is an unacceptable objective of stock reacquisition.

B. To reduce the number of small shareholdings.

The expense of printing and mailing notices, reports, and dividends to small shareholdings "may often be disproportionate to or exceed the earnings on their shares," and for that reason the corporation may wish to eliminate such small holdings.[118] Estimates of the savings involved when a single shareholder can be persuaded to sell range from $10.00 to $1.50.[119] This was the stated objective of a tender-offer by Texam Oil Corp. who viewed the tender as "an attempt to eliminate heavy expenses

connected with small stockholder accounts".[120]

Reacquisition for this purpose is an attempt by the corporation to reduce the cost of achieving a widespread public distribution of shares. This is one of the costs of using the corporate form of organization, and it is not immediately obvious that the number of shareholders should be reduced simply to reduce this cost.[121] Is the service-cost-per-share a significant criteria in this situation? It would seem that widespread share-ownership is desirable as a potential source of future capital and as an avenue of contact with the investing public.

It is not clear that this is an acceptable objective of reacquisition, and if it is acceptable, it can probably be accomplished as simply and as cheaply in another way. The corporation could invite the shareholders to sell to a designated broker-dealer, and offer to pay the selling costs. The costs and difficulty of this procedure should be compared to the costs and difficulty of a tender-offer, which is the only method of reacquisition feasible for this purpose. Since the essence of the operation is to get the shares out of the hands of the small shareholders, and <u>not</u> to get the shares <u>into</u> the hands of the corporation, the broker-dealer arrangement appears superior. Furthermore, this arrangement can be used when a corporation does not have sufficient funds available for repurchase, or has no use for the shares after reacquisition. The only funds required are for the broker-dealers' fees. Furthermore, the corporation would not have the problem of disposing of the shares later.

This objective can be readily accomplished without the use of stock reacquisition, thereby avoiding the potential inequity among shareholders which may accompany reacquisition.

C. Shares reacquired in settlement of debt.

This normally occurs under circumstances where a corporation finds itself in a position to accept its own shares as payment for an otherwise uncollectable account. Legally, a corporation is allowed to accept its shares in compromise of a claim which it holds, even if this necessitates a small payment by the corporation where the value of the shares is greater than the debt.[122] Stevens considers this a bona fide transaction, since it saves the corporation from a loss.[123] This objective of reacquisition is so well established as to be chargeable to capital in many jurisdictions.[124] In the absence of other assets which might satisfy the claim, it is better for the corporation to take back stock in settlement of its claim than to get nothing.

On most grounds, this transaction is innocuous, but room for abuse does exist, in that the value of the shares accepted in compromise may be inflated by the directors of the corporation. Controlling shareholders might sell assets to associates on credit and eventually accept shares at inflated values in compromise of the debt.

This problem of valuation can be avoided, and the basic

objective attained, without the use of stock reacquisition. The corporation is interested in the proceeds of liquidation of the claim, rather than in the shares themselves. The shares could be given in trust to a person other than the corporation to be disposed of in the most beneficial manner, and the proceeds turned over to the corporation. Since it is the large publicly-held corporation considered here, a market for the shares can be assumed. Shares held in such trust could be treated as treasury shares,[125] so that while they are in trust the effect would be the same as if the corporation itself had acquired the shares. This objective -- the advantageous compromise of a debt -- can be achieved by a method other than the reacquisition of the shares by the corporation. The undesirable implications of reacquisition, and the problems of valuation of the shares received, would be avoided by the use of a trustee arrangement.

D. To eliminate fractional shares.

Fractional shares usually result from stock dividends, but may also result from reorganization, mergers, stock-option and bonus plans and conversion of senior securities. Because fractional shares can create administrative and bookkeeping difficulties, and raise questions as to the rights of shareholders, it is normally considered desirable to eliminate such shares.[126] The problem can be avoided by not issuing fractional shares. One alternative would be to give shareholders cash in

lieu of the fractional shares.[127] Another alternative is the issue of scrip for part shares.[128] Scrip is a certificate exchangeable for stock or cash, usually before a specified date. A holder of scrip generally possesses none of the rights of shareholders.[129] Issued for the fractional shares, sufficient scrip may be combined and turned over for a share of stock.

Where fractional shares are issued,[130] it is difficult to find anything objectionable about allowing a corporation to reacquire them. The price could, by statute, be required to be at the market price, since a shareholder could replace the share at that price, and could receive no more for it. However, the objective is the elimination of fractional shares, not the possession of shares by the corporation, and it might be appropriate to have the corporation cancel the reacquired shares.[131]

The volume of the reacquisition could be reduced (especially where stock dividends are a regular policy) if the company arranges with a brokerage firm or bank to buy or sell fractional shares, with the corporation purchasing the remaining fractions.[132] This would still require the corporation's ability to buy any final fractional shares ultimately remaining, but does not require the ability to hold or reissue those shares. The desired effect is to eliminate the fractional shares, and this can be achieved by reacquisition and cancellation.

E. <u>To accept shares received as a gift</u>.

The acceptance of shares received as a gift does not in-

volve the problem of inequity, since it must be assumed that the shares were willingly given up by the shareholder. All remaining shareholders benefit pro rata from the gift, and the shares, once received, would be subject to the same laws and regulations as shares acquired in any other manner -- they are treasury shares. The corporation's ability to receive its own shares as a gift is not objectionable.

VIII - Summary.

The objectives of reacquisition of stock by the publicly-held corporation have been considered on the basis of their acceptability, and in terms of the alternative means available for achieving the objectives.

The following were considered to be acceptable objectives of reacquisition, in some cases in regulated form:

1) The issue of treasury shares rather than unissued shares, with the shares to be reissued to be reacquired by means of proportional reacquisition.

2) The settling of differences with dissenting shareholders, with the corporation required to disclose to shareholders full details of the transaction.

3) In accordance with appraisal provisions.

4) The elimination of fractional shares.

5) The acceptance of shares as a gift.

The following objectives were considered to be unacceptable:

1) The distribution of corporate assets by reacquisition rather than by ordinary dividend. The reason for the use of reacquisition is, to a large extent, tax avoidance. The ordinary dividend distribution is proportional, and not subject to the problem of inequity which may occur with non-proportional reacquisition.

2) Reacquisition for the benefit of only controlling shareholders rather than all shareholders.

3) Reacquisition to improve the corporation's financial position and/or performance.

The remaining objectives, while not inherently unacceptable, are subject to abuse, and furthermore, can be accomplished by alternative means. These alternative means are not subject to the problem of inequity which may be involved with reacquisition.

1) The protection of the control position against the threat of a corporate raider.

2) Miscellaneous objectives:

    a) Trading in the corporation's shares

    b) The reduction of small shareholdings

    c) Settlement of a debt.

Footnotes

1. Those objectives normally associated with the "close corporation" will not be considered. Shares purchased with the intent of "bailing out" a shareholder (or his heirs) in a closely-held corporation, or shares repurchased under a share-repurchase agreement (designed specifically to encourage investment) are excluded here. See Chapter II.

2. Guthart, Financial Analysts Journal, XXIII, No. 2, pp. 105-12. The findings are based on interviews with management of corporations that were active repurchasers during the past decade, as well as more than 100 interviews with brokers, lawyers, educators and financial analysts. p. 105, n. 1. The objectives are considered in slight detail, since Guthart's categories are not identical to those used in the present study.

3. Rapp, dissertation, pp. 112-114. This is compiled from Table 6.1, p. 101, which deals only with industrials. Rapp's information on financial, utility and transportation was restricted but the results were the same in re the relative importance of the reasons for repurchase.

4. Ibid., p. 96. This data summarized from Table 5.13, p. 96. See also his discussion pp. 74-99.

5. Guthmann & Dougall, pp. 622-623. Also Robert W. Johnson, Financial Management (3rd. edition; Boston, Allyn & Bacon, 1966), p. 584.

6. The Brown Shoe Company in 1963 sold the business and assets of G.R. Kenney Corp. for $45,000,000, and offered to repurchase a portion of its outstanding shares from its shareholders. While not an open-market purchase, the company did use repurchase rather than a dividend distribution. Moody's Industrial Manual, 1964. Mangood Corp. in its tender offer said funds for repurchase were available because of the sale of certain assets earlier in the year. Wall St. Journal, December 20, 1965, p. 8. "To shrink the capitalization -- for example, managements of both Consolidation Coal and Whirlpool in the recent past felt that cash had accumulated beyond that necessary for the conduct and expansion of their businesses and both concluded that the acquisition of a portion of the outstanding stock would be advantageous to common shareholders." Goldman, Sachs & Co. -- Memorandum dated June 24, 1963.

7. Guthmann & Dougall, p. 623.

8. The validity of manipulation or support as an objective of reacquisition is discussed later in this chapter.

9. See Bierman & West, The Journal of Finance, XI, No. 4., pp. 687-696.

   Elton & Gruber, The Journal of Finance, XXIII, No. 1, pp. 135-149.

   Woods & Brigham, Journal of Finance and Quantitative Analysis, Vol. I., No. 1, pp. 15-26.

10. See Guthart, Financial Analysts Journal, XXXIII, No. 2, p. 107.

11. Young, dissertation, p. 19.

12. Ibid., p. 18.

13. Ibid.

14. By virtue of Code Sec. 301 (a), 301 (c)(1) and 316.

15. Code Sec. 316 (a). Distributions deemed not to be out of earnings and profits are considered to be a return of capital.

16. Bittker & Eustace, p. 154. See generally pp. 152-160. The Internal Revenue Code nowhere defines the term "earnings and profits", although the effect of a few transactions thereon have been prescribed by statute. In general, it starts with taxable income, allows deductions for dividend distributions of prior years and federal income taxes, and requires that certain tax exempt income be added back. p. 160.

17. Ibid., p. 162. This gives rise to interesting results and highly complex problems. If a partial liquidation, then no part of the distribution will réduce earnings and profits. If the treatment should vary among stockholders under Sec. 302 (b), then the impact on earnings and profits would have to be determined accordingly. For discussion, see Bittker & Eustace.

18. This statement of distributions may have interesting practical consequences, as in the case where a corporation made a distribution by repurchase to distribute redundant funds to the shareholders -- a "partial liquidation" in the financial but not the income-tax sense. Assume that the corporation distributed exactly the amount available according to statute -- the balance in its earned surplus account -- in such manner that the distribution was not taxable at the ordinary income tax rates. In accordance with corporation statutes, the surplus available for dis-

tribution would be reduced by the amount of the distribution, but to the extent that the distribution qualifies for capital gains treatment, the accumulated earnings and profits of the corporation would not be reduced. If the distribution qualified totally for capital gains treatment, then the corporation would have no surplus available for distribution under corporation statute, but would possess the full amount of accumulated earnings and profits for tax purposes.

19. Bittker & Eustace, p. 211. Another author, in a textbook states simply "...a corporation...is subject to a penalty tax if it is used to avoid personal income taxes on its stockholders by allowing its earnings to accumulate beyond the reasonable needs of its business." McCarthy, p. 459, The Federal Income Tax (Englewood Cliffs, Prentice-Hall, Inc., 1968).

20. Internal Revenue Code, Sec. 532.

21. Bittker & Eustace, p. 210.

22. Ibid. Too, tax avoidance need not be the only purpose of non-distribution, although it must be the dominant purpose. Rudick , Harry J., "Effect of the Corporate Income Tax on Management Policies", Harvard Law Journal, II, (1956), pp. 234-253.

23. The Treasury has at its disposal other provisions aimed at tax avoidance -- the Personal Holding Company provision of Secs. 541-47, the Foreign Personal Holding Company provision of 551-58, and the Collapsible Corporation provision in Sec. 341.

24. Wall St. Journal, October 22, 1965, p. 2.

25. Ibid., June 8, 1959, p. 10. (The Company said it would be advantageous from a tax viewpoint to substitute debt for a certain amount of stock.)

26. Guthmann & Dougall, p. 623.

27. Ibid., p. 624.

28. "SEC Watchman Prowl a New Beat", Business Week, May 7, 1966, pp. 53-57.

29. Guthart, Financial Analysts Journal, XXXIII, No. 2, p. 108. Stevenson's dissertation was essentially based on measurements of the impact on book-value. See Appendix I, where the dissertation abstract is presented.

30. "The Final Proof", Forbes (March 1, 1964), p. 13.

31. However, it is recognized that to the extent that investors rely on book-value and change in book-balue as indicators of corporate value, an increase in book-value may result in an increase in market value, thereby resulting in a benefit to the shareholder.

32. Guthmann & Dougall, p. 549.

33. The Continental Insurance Company, Letter to Shareowners, dated May 12, 1966, from the Chairman of the Board.

34. Wall St. Journal, February 11, 1965, p. 13.

35. "The Final Proof", Forbes (March 1, 1964), p. 13.

36. Wall St. Journal, February 11, 1965, p. 13.

37. Anna Merjos, "Into the Treasury", Barrons (August 17, 1964), p. 17.

38. Young, dissertation, p. 19.

39. Guthart, Financial Analysts Journal, Vol. 23, No. 2, p. 109.

40. Ibid. Guthart, in his dissertation, devotes a major portion to a consideration of the proper criterion for this particular "investment" decision.

41. Rundell, C.A., Treasurer, United States Brass Corporation in a Letter, Harvard Business Review, XLIII (November-December 1965), p. 39.

42. The amount by which the cut-off point would be short of r would be a function of the estimate of the rate of tax on the dividend in the shareholders' hands and the rate of return available to the shareholders (since the rate need not =r). These factors lead to the general statement that for the purposes of the distribution decision, the cost of retained earnings is somewhat less than the cost of new equity capital.

43. In practise, the distribution might be made as a reacquisition in the first case but as a dividend distribution in the second.

44. Insofar as the corpoation operates for the benefits of the shareholders, it does so equally for each. It may in fact, or in theory, operate for the benefit of other groups as well.

45. See also the discussion in Chapter VI.

46. Loss, p. 1454.

47. See discussion of manipulation later in this chapter.

48. Moody's Industrial Manual.

49. Ibid.

50. Wall St. Journal, January 8, 1963, p. 15.

51. Warner-Lambert Pharmaceutical, Annual Report, 1964.

52. Hillory, Victor J., "Investing in Yourself: Some Firms Buy More of Their Own Shares as Stock Prices Plunge", The Wall St. Journal, June 30, 1965.

53. Goldman, Sachs and Co., Memorandum, dated June 24, 1963.

54. Warner-Lambert Pharmaceutical, Annual Report, 1964.

55. Wall St. Journal, January 14, 1966, p. 8.

56. Ibid., January 6, 1966, p. 3.

57. Annual Report, 1964, and Moody's Industrial Manual.

58. Proctor and Gamble Corp., Annual Report, 1957.

59. Scott Paper Company, Annual Report, 1966.

60. Federal tax reorganizations, which may be tax-free under the Internal Revenue Code include mergers and consolidations, (Internal Revenue Code of 1954, Sec. 368 (a)(1)(A), as well as Type B and C reorganizations. In a merger, one corporation merges into another and ceases to exist, while the other corporation continues. In a consolidation, the joining corporations form a new, third corporation and cease to exist. Type B reorganizations involve the acquisition by a corporation in exchange solely for voting stock of a controlling interest of the stock of another corporation. [Ibid., Sec. 368 (a)(1)(B).] Type C reorganizations involve the acquisition by a corporation, (including the assumption of liabilities). Ibid., Sec. 368 (a)(1)(C). For a general discussion of the form of merger, see Guthmann & Dougall, pp. 551-582. For the income tax aspects see Bittker & Eustace, pp. 502-533. For a legal discussion see Baker & Cary, pp. 1065-1101.

61. Goldman, Sachs and Co., Memorandum.

62. Leo A. Guthart, Financial Analysts Journal, XXIII, No. 2, p. 108.

63. Anna Merjos, Barrons, August 17, 1964, p. 17.

64. Ed Tyng, The Journal of Commerce, April 19, 1964, p. 17.

65. James D. Fleck, "Corporate Share Repurchasing: An Informal Discussion", Harvard Business School Bulletin (January-February, 1965), p. 8.

66. C.W. Sexton, Vice-President, W.T. Grimm & Co., Letter to the author, dated August 29, 1967.

67. Jonathan Cartwright, "Companies Strengthen Position by Adding to Treasury Stockholdings", The Magazine of Wall Street (January 9, 1965), p. 8.

68. This case is the clearest and most obvious, for no assets are received in return. The case of the merger, as seen below, is confusing because there are earnings attached to the acquired assets, and the amount thereof is uncertain.

69. Assuming the assets distributed were earning at the average rate.

70. The price was $8.00, the eps $1.00, therefore a p/e ratio of 8, and i = 1/8 or 12 1/2%.

71. This might be the case to which the quotation by Sexton refers; the company paid too much, but covered it by fortunate reacquisition. See note 66, this chapter.

72. Federal Trade Commission Ruling, 1943.

73. Loss, p. 653.

74. Borg v International Silver Co., 11F.2d 147 (2d. Cir. 1935); Lattin, p. 426; Henn, p. 262.

75. Baker & Cary, pp. 839-840; Lattin, p. 426; Henn, pp. 262-264.

76. Including Delaware. Ten states provide for sale of shares to employees free from pre-emptive rights, including New York, California, Illinois, Michigan, and Ohio. In a few states, including New York, the vote required is a simple majority. Model Act, Vol. I, pp. 402-405.

77. Henn, p. 265. Only in South Carolina may the pre-emptive right not be denied in charter or by amendment.

78. Baker & Cary, p. 842. Lattin, p. 431. All jurisdictions, in statute, grant the right to amend the articles of incorporation and most provide that the articles may be amended to provide any provision that might lawfully be included in original articles of incorporation at the time the amendment was made. Model Act, II, p. 198.

79. The actual statutory provisions are complex in that they differ in detail, largely because of the way the statutory provision re the pre-emptive rights are framed. While the general tone indicated is correct, for detailed presentation see the Model Act, Sections 53 to 56 and Sec.. 24. See also William D. Ford, "Share Characteristics", Law and Contemporary Problems, XXIII, No. 2 (Spring 1958), pp. 270-272.

80. All jurisdictions except Connecticut, Hawaii, New Hampshire, and Tennessee authorize amendment of the articles to increase the amount of authorized capital. Several states, including Delaware, require class voting thereon, with usually a two-thirds majority required. Model Act, II, p. 199.

81. Young, dissertation, p. 18.

82. As was seen above, the reacquisition transaction is not an extraordinary transaction and can be carried out on the initiative and authority of the directors, without approval of the shareholders.

83. For a case where this was alleged to have occurred, see Word La France Truck Corp., 13 SEC 373 (1943).

84. It has been suggested that this was the intent in the recent Merritt-Chapman case. See reports in the Wall Street Journal, November 23, 1964 , p. 30, and December 2, 1964, p. 2, January 4, 1965, p. 6 especially, but also March 22, 1966, p. 4, June 16, 1966, p. 5, and October 19, 1966, p. 32. Essentially, it was alleged that during 1962 and 1963, the company's own repurchases amounted to 90% of total activity in the stock, and was responsible for the price increase from a low of $11.50 to a high of $18.00 plus. At that point the company called for a tender of shares at $19.00 per share, and indicated that the insider group would sell shares to the corporation. The SEC showed an interest at this point, and the controlling group announced that they would not sell, "on the advice of tax counsel". See also the discussion at note 117 below.

85. This appears to have been one of the Wolfson's aims in the Merritt-Chapman case. The announcement of the tender-offer (Wall Street Journal, October 11, 1965, p. 11), noted that if the indicated shares were repurchased, Mr. Wolfson and his association would end up with a sufficient

majority to control completely the corporation's future.

86. Standard and Poors, Corporation Manual.

87. New York Times, November 29, 1962, p. 51.

88. Anderson vs. Albert & J.M. Anderson Mfg. Co., 325 Mass. 343, 90 NE 2d 541 (1950). This case and others are discussed fully in the following articles directed to this question of repurchase to defeat the threat of the raider.

"The Use of Corporate Funds to Thwart the Control Ambitions of the Corporate Raider -- Time for a Reappraisal?", University of Missouri at Kansas City Law Review, XXXV, p. 335-349.

Victor Brudney, "Fiduciary Ideology in Transactions Affecting Corporate Control", Michigan Law Review, LXV, pp. 259-279.

89. University of Missouri at Kansas City Law Review, XXXV, p. 338.

Brudney, Michigan Law Review, LXV, p. 269.

90. Ibid., p. 273.

91. Ibid., p. 273, University of Missouri at Kansas City Law Review, XXXV, p. 341.

92. Brudney, Michigan Law Review, LXV, p. 271.

93. University of Missouri at Kansas City Law Review, XXXV, p. 341.

94. Brudney, Michigan Law Review, LXV, p. 274.

95. University of Missouri at Kansas City Law Review, LXV, p. 342.

96. Baker & Cary, p. 599.

97. Ibid.

98. Cohen, et. al. v. Beneficial Industrial Loan Corp., 337 US 541, 69 S. Ct. 1221, 93 L. Ed. 15 28(1949).

99. Ibid.

100. Baker & Cary, p. 599. The Model Act provides for appraisal in most cases of merger or consolidation, or sale or exchange of all or substantially all the corporate assets other than

in the regular course of business, Secs. 73 and 74.

101. Lattin, p. 533.

102. Model Act, Sec. 73.

103. Henn, p. 551.

104. Model Act, Sec. 5.

105. Baker & Cary, p. 1052., Columbia Law Review, LXVI, p. 1287. Kessler, Fordham Law Review, XXVIII, p. 649, n. 39.

106. FTC Release No. 131, March 13, 1934; Baker & Cary, p. 1052.

107. Kessler, Fordham Law Review, XXVIII, p. 649, n. 39.

108. Israels and Duff. When Corporations Go Public, New York Practising Law Institute: 1962, p. 71.

109. A.A. Berle, "Liability for Stock Market Manipulation", Columbia Law Review, XXXI (1931), p. 264.

110. For a general discussion of manipulation, see Loss, pp. 1529 to 1570, especially p. 1541.

111. Securities Exchange Act Release 4163 (1948).

112. Loss, p. 651, n. 34.

113. Securities and Exchange Commission Act, Sec. 9(a)(2).

114. Sidney Robbins, The Securities Markets (New York: The Free Press, 1966), p. 86.

115. Wall St. Journal, May 10, 1966, p. 6.

116. Ibid.

117. Wall St. Journal, November 23, 1964, p. 30. This is really a case of controlling shareholders utilizing corporate assets for their own ends discussed above. This transaction was not carried out, for Wolfson disclosed shortly (WSJ, December 2/64, p. 2) that he and his associates would not tender stock, on "the advice of tax counsel". However, at about the same time, it became known that the SEC was showing interest in the repurchase activity of the corporation. WSJ, December 3, 1964, p. 2.

118. Zilber, University of Cincinatti Law Review, XXXIII, p. 319.

119. "It pays to buy out small stockholdings," Business Week (December 5, 1964), p. 144. According to this source, these efforts have not met with great response, even though shareholders can save the usual selling fees and commissions by selling to the corporation rather than through a broker-dealer.

120. Wall St. Journal, November 5, 1965, p. 28. United-Whelon Stores, Corp., Ward Baking Co., and Vulcan Materials have also sought tenders for this purpose. See Zilber, University of Cincinatti Law Review, XXXIII, p. 319, n. 21.

121. "Still another criticism of corporate stock repurchases is that they tend to shrink a company's list of shareholders -- and thus run counter to the NYSE long-running "Own your share of American Business" campaign to increase the number of Americans...who own shares in publicly-held corporations. Some in the exchange community consequently take a dim view of such reacquisitions, although the exchange itself has said nothing." Hillory, The Wall Street Journal, June 30, 1965, p. 8.

122. Kessler, Fordham Law Review, XXVIII, p. 657.

123. Stevens and Henn, p. 278.

124. Kessler, Fordham Law Review, XXVIII, p. 657. See Model Act provision, discussed in Chapter IV.

125. The shares would not be voted, nor would dividends be paid thereon, nor would they be counted in determination of a quorum -- in short, they would not be outstanding.

126. Fractional shares are denied voting rights (Henn, p. 241). There is doubt as to the dividend rights of the shares, and case law concerning fractional shares is almost non-existent. (Kessler, Fordham Law Review, XXVIII, p. 246.) The matter is not even discussed by Baker & Cary, or Lattin.

127. Such amount of cash -- but not the total distribution -- would be taxable in the hands of the shareholder as a dividend. This is based on Special Ruling, December 21, 1960, CCH., p. 2334. 115. Previous to that ruling, it would appear that under Internal Revenue Code Sec. 305 (b)(2), the total distribution would be taxable if any part thereof would be available in cash. In re the rul-

ing, the corporation had not given the shareholders choice about any part of the distribution, but paid all whole shares in stock, and all part shares in cash. This taxability of the cash distribution would not be expected to be very significant since the maximum amount per shareholder could not be greater than 99% of the value of one share.

128. Loss says that this occurs "not infrequently", p. p. 651.

129. Ibid.

130. Not all jurisdictions currently allow the use of scrip. Henn, p. 241.

131. The corporation might not want to resell the shares, because if the distribution was exempted from registration under Sec. 3(a)(9) of the Securities Act, the reissue for cash might destroy the exemption and require the entire operation to be registered. Loss, p. 651. (For example, a stock dividend would normally be exempt from registration.)

132. Loss suggests this procedure for dealings with scrip, and makes the point that if "the arrangements are clearly such as to make the broker or bank the agent of the scrip holders and not of the issuer", the transaction would not destroy the exemption from registration. Loss, p. 651. This would appear to apply equally well to the purchase of part shares and resale of whole shares; therefore, the corporation would not wish to resell, but could have a broker handle the deal, "for the shareholder".

CHAPTER VIII

Recommendations.

Any recommendations concerning the regulation of stock reacquisition must be made in the context of the current legal, regulatory and tax environment. Such recommendations should attempt to maximize the use of existing regulations and minimize the disruption of established practice while still achieving the effect desired. The reacquisition transaction is well established as a technique of corporate financial management, and there is justification for some hesitance in recommending measures which would severely curtail the transaction or significantly alter its nature. The problem is one of conflicting goals; on the one hand is the desire to allow the continuation of a well-established corporate practice, while on the other is the desire to eliminate or preclude the objectionable implications of stock reacquisition. Ballantine, in discussing the general problem of restricting management's right of action, comments:

> "A serious dilemma in drafting a corporation law is to make it liberal enough to facilitate business transactions without undue formalities of checks and balances, of votes and consents of shareholders, and applications to the courts, and at the same time not so lax that the management or the majority may manipulate the machinery to the prejudice of creditors or investors or to the oppression of minority shareholders."[1]

Levy, recognizing the problem of restricting manage-

ment's rights as it applies specifically to stock reacquisition, takes a position similar to that of the present study:

> "The mere possibility of abuse is not of itself an argument against permitting a practise which may be useful. But in the realm of corporation finance and management, the readiness with which a power may be and is being abused may be a valid reason for its abolition, especially when...the valid functions it serves may be performed by less volatile agencies."[2]

He refers also to the inadequacy of relying on the Court to control the potential abuses of reacquisition, in the absence of specific regulation:

> "No doubt discerning courts should and will prevent the purchase of a company's own shares when done fraudulently or when it conflicts sharply with well organized and superior legal interests. But there is an entire lack of agreement as to what is an abuse of the power, and in some jurisdictions equitable relief can be expected only against its grosser and more flagrant manifestations. To be forced to seek recourse to an equity action to restrain the abuse of a power, conceded to exist, is at best a doubtful and inadequate remedy..."[3]

The need for further and more effective regulation, indicated in Chapter IV, is recognized currently by many.[4] Offsetting the need for more effective regulation is the degree to which the transaction is established in the law, and the resistance with which a suggested change in regulation is likely to be met. Kessler, writing as recently as 1960, concludes:

> "Most legal writers who have examined the problem of a corporation's repurchase of its own shares

> have condemned the generally permissive American rule. In the face of almost universal permission accorded by American Law to some form of corporate share repurchases, and the ever more sweeping grant given by modern corporation statutes, led by the Model Act, such expectation is too sanquine, at least until America suffers a South Sea Bubble or an economic crisis like that experienced by Germany after World War I. Until such unwelcome disasters, critics of unrestricted corporate share purchases will remain unheeded voices crying in the wilderness."[4]

Recognizing this conflict between the prevention of abuse on the one hand and the restriction of the corporation's freedom to operate on the other, and recognizing also the legal and regulatory environment into which they are introduced, three alternative recommendations are presented for consideration. (Certain less-significant alternatives are discussed very briefly in a subsequent section.)

I - <u>The prohibition, with exceptions, of stock reacquisition</u>.

This is the recommendation preferred by the author because it follows logically from the conclusions reached in the study. The reacquisition of stock should be prohibited except for the following purposes:

i) the elimination of fractional shares

ii) the acceptance of shares received as a gift

iii) the repurchase of shares in accordance with "appraisal remedy" provisions

iv) repurchase to eliminate dissenting minority shareholders.

The four exceptions are either necessary or highly useful, and are generally not subject to abuse. The elimination of fractional shares is a necessary power of the corporation. The accepting of shares received as a gift has no objectionable implications, and like repurchases made in accordance with appraisal remedy provisions, the transaction is not initiated by the corporation. The latter transaction currently is subject to regulation, and plays a useful part in corporate democracy by allowing dissent by the minority from the binding opinion of the majority. The elimination of dissenting minority shareholders -- subject to shareholder review -- can be a highly desirable objective of reacquisition.

The price to be paid for the fractional shares should be the market price. Price is irrelevant in respect to shares received as a gift, and the appraisal remedy provisions normally provide for the determination of the price. Purchases to eliminate dissenting shareholders require a certain latitude on the part of management, who should be held to act in "good faith and the best interests of the corporation".

While this approach would preclude all the potentially undesirable implications of reacquisition, it would also eliminate the transaction as a part of deliberate corporate financial policy. However, as was seen in Chapter VII, the legitimate and meaningful objectives of reacquisition can be achieved by other means such as ordinary dividend distributions or proxy contests. Where other means of achieving desirable

objectives are not available, exceptions have been made to allow reacquisition.

II - Require that all reacquisitions be pro rata.

The four exceptions given above would now be exceptions to the pro rata requirement, since such reacquisitions are necessarily other than pro rata. In addition, the preemptive right would apply to treasury shares in the same way as to previously unissued shares. Such a pro rata requirement would have several significant effects:

1) It would preclude potential inequity among shareholders and would render the reacquisition price unimportant.
2) It would eliminate, with the indicated exceptions, all objectives of reacquisition which require non-proportional reacquisition including reacquisition to effect the position of the controlling group (whether for the benefit of the group or to protect against the corporate raider), and reacquisition to eliminate small shareholdings or in settlement of a debt. It would not eliminate those objectives involving trading in shares, but they are already subject to considerable regulation.
3) The proportionality requirement would eliminate all open-market and direct private purchases of its shares by the corporation, since these methods are inherently non-proportional. It would also require changes in the public tender offer to make it proportional.

4) Under the current income tax provisions, the proportional reacquisition would be taxable as an ordinary dividend, with the exception of distributions which qualify as a partial liquidation. This could be expected to reduce the incentive to the reissue of treasury shares rather than new shares, to the reacquisition of shares for such purposes as "increasing leverage", and the use of reacquisition instead of a dividend distribution.

While the proportionality requirement would eliminate those objectives considered unacceptable, and preclude inequity in connection with acceptable objectives, there would be practical difficulties with this requirement. If a corporation were simply to offer to purchase an identical percentage of each shareholders' shares, the refusal by even one shareholder would frustrate the plan. It could be suggested that the shareholders give prior approval for the reacquisition and that dissenting shareholders be given an appraisal right. In that case, the dissenting shareholders would still sell their shares to the corporation, but at an "appraisal" price. This could result in different prices for the two groups and would re-introduce the problem of inequity among shareholders.

A solution would be to give the corporation the right to require each shareholder to sell the appropriate part of his holdings. (De facto, this power already exists -- through a combination of an ordinary dividend and a reverse stock

split.) A requirement that all shareholders must sell their pro rata share would be no different than an ordinary dividend, in that each shareholder must share in the distribution. True, with a dividend the number of shares outstanding and held by the shareholder is not altered. However, in a proportional reacquisition, while the numbers involved are changed, the proportional significance of a specific holding of shares is unchanged as in the case of a dividend. It would seem appropriate to give the corporation the right to require every shareholder to participate in a proportional reacquisition, thereby rendering the proportionality requirement workable.

Proportional reacquisition (rather than outright prohibition of reacquisition) would allow the use of treasury shares rather than new shares to avoid increasing the number of shares outstanding, and would allow reacquisition to "improve the corporation's position". Given proportionality of reacquisition, these are not meaningful objectives, and this fact might be expected to become recognized by management and shareholders alike. In addition, the applicability of the pre-emptive right to treasury shares, the taxability of reacquisition distributions in the hands of shareholders, and the requirement of a formal proportional reacquisition procedure would all help to reduce considerably the practical significance of the reacquisition transaction. As such, the pro rata requirement might have much the same effect as out-

right prohibition.

III - Require that all reacquisitions be made by means of a public tender offer.

The third alternative would be to require that all reacquisitions be made by public tender offer, again with the four exceptions indicated above and the recommendation concerning the applicability of the pre-emptive right to treasury shares. The tender offer would be accompanied by maximum disclosure of information to shareholders. So as to further preclude the favoring of specific shareholders by the corporation, the selection of shares to be purchased from among those offered would be pro rata.

The tender offer requirement differs significantly from requiring proportionality in reacquisition, since a pro rata offer does not ensure a pro rata purchase, and inequity may still result. However, the use of the public tender offer would eliminate those objectives which require deliberate non-proportionality, since the corporation would be unable to select the shares to be purchased.

Given the structure of the income tax provisions, tax avoidance could still be an objective of reacquisition, since the individual shareholder would be able to conduct his own affairs so as to make the proceeds of sale eligible for capital gains tax in his hands. Although the corporation cannot be fully selective in choosing shares to purchase, the insider may utilize his knowledge in deciding whether or not

to tender, or even in deciding when to have the corporation make a tender offer. However, the basic objection to the tender offer is the problem of inequity among shareholders. Adequate disclosure may eliminate the problem of a lack of information on the part of the shareholder, but it cannot eliminate the shareholders' inability to make the correct decision concerning the attractiveness of the price offered. However, the responsibility of the individual for his own decisions is an accepted part of the philosophy of securities regulation in the United States. It is not necessarily true that the regulations of the reacquisition transaction should go further in protecting the shareholder from his own ignorance and inability than does regulation in respect to other share transactions. On the other hand, the stock reacquisition transaction is not the same as an ordinary stock transaction, and a different approach to protecting the shareholder may be warranted. The risk of inequity is present with the use of the public tender offer since it does not ensure proportional reacquisition. Since the acceptable objectives of reacquisition can be attained by other means, should the shareholder be subjected to this risk?

IV - Miscellaneous alternatives.

There are several other alternatives which might be considered. They are more specific and less comprehensive than the three alternatives considered above, and are generally

aimed at specific abuses of the corporation's right to reacquire shares.

i) Require the prior approval of a majority of the shareholders before specific, identifiable reacquisitions of shares. This proposal would make the transaction lengthy and involved, and would remove it from the discretion of the board of directors. Also, prior approval of tentative plans would involve disclosure of information which might jeopardize deals and plans which require confidential treatment.

ii) Require the prior approval of all shareholders other than those from whom the shares will be purchased. This would operate to prevent favoritism on the part of the corporation, or on the part of the controlling shareholders.

iii) Require that all repurchases be made on the open-market at the market price. This would rule out all objectives which require the ability to select the shares to be repurchased, including some of the objectives included in the "exceptions" category above. The use of market price as <u>the</u> solution to the problem of inequity has been discussed above in Chapter VI, where it was rejected.

iv) A fourth general alternative is to concentrate on disclosure of information concerning reacquisition transactions. Require disclosure, of all material information before reacquisition and of all relevant facts after

reacquisition, to the shareholders. Because unhappy shareholders could bring suit against the corporation, this will operate to prevent inappropriate reacquisitions. In theory, this is already the current situation.

The above four proposals have in common that they operate to prevent only deliberate abuse of the reacquisition transaction. More significantly, they implicitly assume either that, given the right information, the shareholders will be able to make the correct decision and preclude inequity, or, that the shareholder need not be protected against the inequity which may result from his own inability to make the correct decision. The position can be taken that such an approach does not ensure adequate protection of the shareholders' interest.

V - Conclusion.

The alternatives considered significant -- prohibition, a proportionality requirement, or the tender-offer requirement -- would differ significantly in their practical effects on the reacquisition transaction. The choice between them will depend on how the potential inequity of reacquisition is viewed. If the inequity is considered to be so significant as to warrant its preclusion at the price of virtually eliminating reacquisition, then one of the first two recommendations will be chosen. The proportionality requirement would preclude the

potential inequity, but would allow reacquisition to continue.

If the position is taken that the shareholder should be extended no greater protection in dealings with his corporation than in ordinary share dealings, then the public tender offer recommendation will be preferred. This implies the willingness to treat the reacquisition transaction as if it were an ordinary share transaction (as defined in Chapter VI).

In terms of practicality of implementation, the public tender offer is probably the most feasible recommendation. Coupled with adequate disclosure and provision for the selection of shares from among those tendered, the tender-offer eliminates, to a considerable extent, deliberate utilization of inequity. Given adequate disclosure, the inequity resulting would be the result of shareholders' inability to correctly assess the desirability of the offer. As such, this would be a significant improvement over the present regulatory situation.

Footnotes.

1. Henry W. Ballantine, "Questions of Policy in Drafting a Modern Corporation Law", California Law Review, XIX, No. 5, p. 465.

2. Irving J. Levy, Minnesota Law Review, XI, No. 1 (December 1930), p. 7.

3. Ibid.

4. See generally, for instance:

   "Rule 10b-5 and Purchase by a Corporation of Its Own Shares", Northwestern University Law Review, LXI, No. 2 (May-June 1966), pp. 307-328.

- and -

"Corporate Stock Repurchases Under the Federal Securities Laws", Columbia Law Review, LXVI, No. 7 (November 1966), pp. 1292-1301.

Manuel & Cohen, "A Note on Takeover Bids and Corporate Purchases of Stock", The Business Lawyer, XXII, No. 1, pp. 149-157.

Kessler, Robert A., "Share Repurchases Under Modern Corporation Laws", Fordham Law Review, XXVIII (1959-1960), pp. 637-688; especially p. 644.

5. Kessler, Robert A., Fordham Law Review, p. 680.

APPENDIX I

Abstracts of four recently completed dissertations.

The role of reacquired common stock in financial management.

Wilbur A. Rapp

Dissertation Abstract

THIS STUDY EXAMINES the role of reacquired common stock in financial management. A small portion of the study is devoted to a discussion of the research methodology used. Another small portion is devoted to a survey of the financial literature available on the subject of common treasury stock. Wherever the findings of this study differ from the hypotheses advanced in the financial literature, the differences are pointed out.

All of the 1,217 companies that had common stock listed on the New York Stock Exchange on August 4, 1964, were chosen as the universe. Each company was classified as an industrial, financial, transportation, or utility company. Each company was examined each year for the thirteen-year period 1959-63, inclusive, to identify those companies that repurchased and those repurchasers that used some previously reacquired common stock. Approximately 45 per cent of the companies listed, engaged in treasury common stock financing, but the extent and pattern both of repurchase and of use differed among the four groups. The sources of data were the appropriate Moody's Manuals and corporate annual reports.

The repurchasing companies' past and planned uses of treasury common stock, methods of acquisition, methods of financing, and stated reasons for repurchase were determined by a questionnaire study. The characteristics of repurchasers were related to the relative amounts of stock that they reacquired, their uses of it, and their reasons for repurchase.

What factors contributed to the significant increase in treasury common stock financing? The factors identified were a more favorable federal income tax environment, a substantial increase in the number of corporations that adopted stock option plans as a form of reacquisition, the level of stock market prices, and an increase in cash flow.

After the empirical findings of the study are presented, two situations found frequently are discussed. In the first one, the company repurchases a relatively small proportion of its common stock, holds it for an indefinite period of time, and then uses it for compensation plans or for mergers. The conclusions arising from this discussion are that the remaining shareholders may benefit from increased book value, earnings, and market price per share, and the repurchasing company may earn a higher rate of return on its investment in its own common stock than on alternative investments.

In the second situation, the corporation reacquires a substantial proportion of its common stock. Since the reacquired stock is not used, the success of repurchase has to be measured in terms of the resulting effect on book value, earnings,

and market price per share. The conclusion arising from this discussion is that repurchase may have a favorable effect, but the effect of repurchase on market price is difficult to ascertain because there are many variables involved.

The principal conclusion of the study is that treasury common stock financing has come to play a prominent role in financial management. Financial management is concerned with capital budgeting, maximizing the present value of the corporation, treating shareholders equitably, efficient allocation of resources, and liquidity and profitability. Treasury common stock financing is playing an important role in all of these areas because it is providing financial managers with a flexible method of financing that they can use in the best interests of the corporation and the shareholders.

THE REACQUISITION OF CORPORATE STOCK

Richard Andrew Stevenson

Dissertation Abstract

One of the most significant changes within the area of corporate finance is the recent upsurge in the reacquisition of stock for the corporate treasury. This study is concerned with the factors leading to the stock reacquisition and with its ramifications -- both financial and non-financial.

The sample used was chosen by taking all New York Stock Exchange industrial companies reducing their outstanding

common stock by one percent or more in any year during the 1956 to 1963 period. This methodology yielded 254 separate reductions in common stock outstanding. In total, 160 companies were involved.

These companies were analyzed to determine their characteristics. Characteristics examined included quality, liquidity, size, profitability, and capital structure. The companies reacquiring stock and other stock groups were compared. It was found that the quality of companies reacquiring their own stock slowly improved during the period. The size of companies reacquiring stock tripled from the 1956-1959 period to the 1960-1963 period. The sample companies had both significantly greater liquidity and lower rates of return on assets and net worth than the typical New York Stock Exchange company. Capital structures of the sample companies varied considerably more than did the capital structures for other representative groups. The main change was an eight percent decline in common stock equity from 1956 to 1963 accompanied by a roughly equivalent increase in the percentage of debt as debt was substituted for equity.

A model was developed to determine the rate of return on common stock reacquisition. In testing this model on the stock reacquisitions during 1956-1963, it was found that 55% of the companies tested had rates of return in excess of 15.0%. The model can also be used to determine the attractiveness of a proposed stock repurchase.

Other problems analyzed included the timing of the reacquisitions, the ethical implications, and the role of the book value-to-market value ratio. The conclusions are as follows:

1. Stock repurchase involves less downside price risk than a typical stock purchase partly because companies reacquiring stock already tend to be undervalued by the market as a result of their characteristic liquidity, profitability, etc.

2. Ethical considerations need more attention especially regarding the disclosure of open market purchases in the financial press.

3. The ratio of book value-to-market value was significantly higher for companies reacquiring stock than for typical New York Stock Exchange companies. However, a simple correlation between the percentage of stock reacquired and the ratio of book value-to-market value was not significant and was, in fact, very close to zero.

MANAGERIAL, MARKET AND INVESTOR PROBLEMS ASSOCIATED WITH THE CASH TENDER OFFERS OF EXCHANGE LISTED CORPORATIONS FOR THEIR OWN COMMON STOCK

Allan Edward Young

Dissertation Abstract

In recent years, the number of cash tender offers of corporations for their own common stock have increased at a

rapid rate and, at the present time, occur frequently. While during the first 214 months of the period December 1944 to October 1965, 94 instances of exchange listed corporations issuing cash tender offers occurred, in the latter 36 months of this period there were 58 such offers. This dissertation studies these offers in terms of both their effect upon and how they, in turn, affect the three institutions or interest groups most closely related to them -- management, the trading markets, and the investor.

It was found that the management of tendering corporations undertook this procedure primarily when book value was 25% or more above market value, when earnings were declining, and when net assets were increasing. In addition, smaller companies issued the preponderance of tender offers. Finally, excess liquidity and the situation which created this condition were important factors in motivating management in the tender decision in a substantial number of cases. With regard to the manner in which the management of tendering corporations undertook this procedure, a positive and significant coefficient of simple correlation was found between the premium above the prevailing market price management paid and each of the following: the number of shares management requested from stockholders; the size of the company; the liquidity of the company; and the degree of mutual acceptance of the proposal. Finally, a positive and significant coefficient of multiple correlation was present when the premium was taken as the dependent variable

and each of the above variables were included as independent factors.

In relation to the effect of trading market conditions upon the propensity of corporations to issue tender offers, corporations with a greater number of stockholders owning a small number of shares issued the preponderance of tender offers. Tender offers were far more numerous when both the general price movement of the equity markets and the degree of overall economic activity were rising than when they were declining. When looking at the effect of tender offers upon the trading markets, it was found that trading volume declined substantially subsequent to the offer from the level prevailing prior to it. And, although there was no significant change in the spread between the high and low trades during the period prior to the offer and the period subsequent to this event, the index of marketability, (volume/spread), declined significantly subsequent to the offer. Moreover, there were a substantial number of cases in which de-listings or an acute drying up of trading volume followed hard upon a tender offer.

In relation to the effect of tender offers upon investors, the performance of all tendered common stocks subsequent to this event was significantly less favorable than the general market for equity securities. Further, the subsequent performance of common stocks for which tender offers were issued when net assets were rising was superior to the performance of those for which tender offers were issued when net assets

were declining. Similarly, subsequent performance was superior if market value exceeded book value at the time of the offer than if the reverse relationship held. Also, the smaller the proportion of liquid assets a corporation held at the time of this offer and the larger the company, the better the subsequent performance of the stock. And when the proportion of shares management asked stockholders to tender was larger, the subsequent price action of the stock was superior. Finally, the greater the premium management offered, the better the subsequent performance of the stock.

CORPORATE REPURCHASES OF ALREADY OUTSTANDING COMMON STOCK

Leo A. Guthart

Dissertation Abstract

THE PURPOSE OF THIS STUDY is to investigate the important aspects of the decision by a corporation to repurchase its own common shares. In general, the work has been organized along the lines of the three major issues presented by share repurchase.

The first important issue underlying the entire practice of share reacquisition is the equitability of the corporation's action to the stockholder who sells. Is there a conflict of interest on the part of the management group when the company buys shares from its own stockholders? Is the corporation act-

ing on the basis of "inside" information that is not available to the selling stockholder? Should the stockholder be made aware of the fact that the corporation is repurchasing his shares? Should the SEC require more disclosure of corporate repurchases of their own common stock? Is the tender method of reacquiring own shares more equitable than purchasing on the open market?

Chapters II and III of this study consider these aspects of share repurchase and conclude that a major "gray" area, which urgently needs resolution, exists in the body of law regulating share repurchase activities. The author takes the position that substantial possibilities for abuse of stockholders exist when corporations repurchase their own shares and makes policy suggestions regarding improved disclosure and stockholder notification procedures.

Chapters IV and V present a comprehensive analysis that has been conducted of any share repurchasing accomplished by New York Stock Exchange firms during the years 1954-1965. The study concludes that share repurchasing has been an important factor in the stock market in the past ten years, that it is on the increase, and generally that it is of roughly the same magnitude as stock market forces acknowledged to be highly significant, including common stock buying by (1) mutual funds, (2) pension funds, and (3) life insurance companies. Between 1954 and 1965, the number of shares repurchased by New York Stock Exchange companies increased from 5.8 million to 38.7 million

shares. In dollar terms, it was estimated that almost $2 billion was applied to share repurchase in 1965.

In addition to these overall data, the study traced the share repurchase activities of companies that were considered "active repurchasers." During the decade 1954 to 1963, 355 different companies accounted for 5% or more of trading in their own stock by their own repurchases during at least one year. In fact, this "active" group bore an average relationship to trading in their own stock of 18.9% by their own purchases.

In Chapter VI, the study considers the question of how the financial decision to repurchase common shares should best be approached. On the basis of interviews conducted with companies that were active repurchasers, tabulations are presented of the various reasons why companies buy their own shares. The field interviews showed that the most significant motivations for repurchasing common shares were (1) to shrink the equity base, (2) to avoid increasing the equity base as future requirements for new stock arose, and (3) to make a good investment. In addition, analyses are presented of the important yardsticks used to evaluate repurchase. The study found that the relationship of market value to book value was by far the most important of these yardsticks. Finally, the study reported on current practice regarding advance notice to shareholders.

In Chapter VII, a discussion is directed to the businessman of the methods by which the share-repurchase decision can

best be approached. This analysis is intended to be of practical value to active businessmen when considering the share-repurchase alternative. It attempts to place the share-repurchase investment decision in terms which make it readily comparable with alternative capital investment proposals ranked by the discounted cash flow (present value) approach.

APPENDIX II

The effect on eps of reacquisition.

If E = total earnings before reacquisition
S = shares outstanding before reacquisition
s = number of shares reacquired
D = assets distributed
i = rate of return on D
P = price paid per share
per = the price/earnings ratio before reacquisition

$$r = \frac{1}{per}$$

then, let $eps_b = \frac{E}{S}$ = eps before

and $eps_a = \frac{E - (D)(i)}{S - s}$ = eps after

now $s = \frac{D}{P}$, and $P = per\ (\frac{E}{S})$,

so $$s = \frac{D}{per\ (\frac{E}{S})} = D\ [\frac{1}{per}\ (\frac{S}{E})] = D\ [r(\frac{S}{E})]$$

and $$eps_a = \frac{E - (D)(i)}{S - D[r(\frac{S}{E})]},$$

$$= \frac{E - Di}{S - Dr\ (\frac{S}{E})}$$

It can be shown that

if $r = i$, then $eps_a = \frac{E}{S}$,

if $r > i$, then $eps_a > \frac{E}{S}$ and

if $r < i$, then $eps_a < \frac{E}{S}$

To demonstrate that if $r = i$, then $\frac{E}{S} = \frac{E - Di}{S - Dr\ (\frac{S}{E})}$,

multiply by $\frac{1}{E}$, $\frac{E}{ES} = \frac{E - Di}{ES - DrS}$

simplifying, $\frac{1}{S} = \frac{E - Di}{S(E - Dr)}$

multiplying by S, $1 = \frac{E - Di}{E - Dr}$

substituting r for i, $1 = \frac{E - Dr}{E - Dr}$, and

$$1 = 1$$

To prove that if $r > i$, then $\frac{E}{S} < \frac{E - Di}{S - Dr(\frac{S}{E})}$,

multiplying by $\frac{S}{E}$, and simplify,

as above, $1 < \frac{E - Di}{E - Dr}$,

multiply by $\frac{E}{S}$, $\frac{E}{S} < \frac{E}{S}\ [\frac{E - Di}{E - Dr}]$, which holds

true if $r > i$.

Similarly, if $r < i$, then $\frac{E}{S} > \frac{E}{S}\ [\frac{E - Di}{E - Dr}]$

APPENDIX III

The legal interpretation of "Capital" and "Surplus".

The Model Business Corporation Act, Section 2.

(j) "Stated capital" means, at any particular time, the sum of (1) the par value of all shares of the corporation having a par value that have been issued, (2) the amount of the consideration received by the corporation for all shares of the corporation without par value that have been issued, except such part of the consideration therefore as may have been allocated to capital surplus in a manner permitted by law, and (3) such amounts not included in clauses (1) and (2) of this paragraph as have been transferred to stated capital of the corporation, whether upon the issue of shares as a share dividend or otherwise, minus all reductions from such sum as have been effected in a manner permitted by law. Irrespective of the manner of designation thereof by the laws under which a foreign corporation is organized, the stated capital of a foreign corporation shall be determined on the same basis and in the same manner as the stated capital of a domestic corporation, for the purpose of computing fees, franchise taxes and other charges imposed by this Act.

(k) "Surplus" means the excess of the net assets of a corporation over its stated capital.

(l) "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, in-

come, 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.

(m) "Capital surplus" means the entire surplus of a corporation other than its earned surplus.

Garett summarizes the historical development of the trust-fund doctirne as follows: "In early corporation statutes, the interests of stockholders were divisible into two categories -- capital and surplus. The capital of a corporation was the amount that the proprietors agreed to invest in the enterprise and was measured by the aggregate par value of the shares of stock issued or subscribed for. The courts soon imposed on this statutory concept the trust-fund doctrine, which regarded assets equal to the amount of capital as the trust-fund for the protection of creditors. Whenever the assets were less than that amount,the proprietors were not entitled to make distributions to themselves, but whenever the assets exceeded that amount, the excess was regarded as surplus and was freely distributable to the proprietors, because it was necessarily derived from the profits of the business. Since no particular assets were earmarked for creditors and there was no actual fund, the doctrine was nothing more than a restriction on the amount

of assets that could lawfully be distributed to the proprietors." p. 239.

Kessler interprets stated capital as follows:

> "A corporation's 'stated capital' or 'capital,' in its correct usage, is therefore, merely the 'answer' obtained by applying a general mathematical formula (the legal 'definition') to the individual corporate variables. This 'answer' tells the corporation the amount of assets which public policy dictates it must keep on hand...for adequate protection of its creditors or shareholders rights." p. 642.

Garett interprets the MBCA definitions as follows:

> "The theory of the Model Act is that net assets will provide for the claims of creditors ahead of shareholders, that stated capital will provide for the permanent investments of shareholders; that capital (or paid-in) surplus will represent, in the first instance, a portion of the investments of shareholders that is less permanent but subject to special protective rules; that earned surplus will represent the accumulated and undistributed profits; that upstream transfers from earned surplus to capital surplus or stated capital should be largely discretionary with the board of directors, but downstream transfers should generally require the approval of shareholders; and that the whole purpose of the formula and restrictions accompanying it is to state when and under what circumstances corporate assets can be distributed to the shareholders. All of the new statutes employ the same theory, and variations among them reflect local preferences as to details, rather than departure from basic theory." p. 242.

APPENDIX IV

The effect on the interest of the shareholder. Part I

The variables which determine the effect of a reacquisition on a shareholder can be identified, and the relationships between them demonstrated with the aid of a simple mathematical formulation and two tables which follow directly. Both the change in the value of the shareholder's interest and in the voting position of the shareholder are dealt with. Part I of this appendix presents the formula for the change in value of the interest of the shareholder, demonstrates the formula's use. Part II contains the formal mathematical demonstration of the relationships in respect to change in voting position as well as change in the value of the shareholder's interest.

The change in the value of the interest of the shareholder as a result of reacquisition of stock by the corporation - ΔI - is equal to:

$$= \left[\frac{V - apS}{(1 - a)S}\right] bs + ps\ (1 - b) - \frac{sV}{S}$$

where V = the total value of the corporation before reacquisition

S = original number of shares outstanding

a = fraction of total share outstanding repurchased by the corporation

p = repurchase price per share

s = number of shares individual held before reacquisition

b = fraction of shares individual holds and does not sell

This is the general formula for the change in the value of the shareholder's interest as a result of a sale of shares by the shareholder and/or a repurchase of shares by the corporation. The value of the shareholder's interest is measured by the total of the (i) proceeds of disposal of shares and (ii) the value of unsold shares; the change in value is the difference between (i) the sum of these two amounts and (ii) the value of the shareholder's shares before the transaction.

The formula is useful in demonstrating the difference between a repurchase transaction and an ordinary stock transaction. When a shareholder sells shares to a buyer other than the corporation, his gain or loss is measured simply by the difference between the proceeds of sale and the value of the shares. When the corporation is the purchaser of the shares, then the gain or loss includes also the change in value of the unsold shares -- as a result of the repurchase -- as well as the gain or loss on any shares actually sold.

If the shareholder sells shares in an ordinary transaction (the corporation is not the purchaser of the shares), then a=o, and the formula for ΔI reduces to $(s-bs)\ (p-\frac{V}{S})$.

$$\Delta I = \left[\frac{V-apS}{(1-a)S}\right] bs + ps\ (1-b) - s\ \frac{V}{S}$$

If a = o, then the first term becomes $(\frac{V}{S})\ bs + ps\ (1-b) - s\frac{V}{S}$

$$= ps\ (1-b) + (\frac{V}{S}) - s\ (\frac{V}{S})$$

$$= p\ \ (s-bs) + \frac{V}{S}\ (s-bs)$$

$$= (s-bs)(p-\frac{V}{S})$$

The ΔI is equal to (s - bs) (which indicates only the number of shares sold), multiplied by the difference between the price paid for the shares and the share value. Where the corporation is not involved in the transaction, there is no other change in value to consider.

If the corporation repurchases, (a>o) but the shareholder sells no shares (b=1.o), the ΔI is <u>not</u> zero. Where b=1.o, the term ps(1-b) becomes zero but the formula $\left[\frac{V-aps}{(1-a)S}\right]bs - s\frac{V}{s}$ remains, demonstrating that a shareholder is subject to the effects of a corporate repurchase whether or not he sells shares.

In a repurchase transaction where the shareholder sells <u>all</u> of his shares, the ΔI is measured simply by the difference between the proceeds of sale and the value of the shares, since the shareholder retains no interest in the corporation. In such cases, b = 0 and the formula reduces to $s(p-\frac{V}{S})$, since the term

$$\left[\frac{V - apS}{(1-a)S}\right] bs \quad \text{disappears.}$$

The shareholder considering the sale of all of his shares can approach the decision to sell his shares to the corporation in the same way as he would any other sale of shares; <u>but only in this one case</u> (of the sale of all of shares) is this true.

In any particular reacquisition, the values for V, S, and s immediately before reacquisition are given, and the effect on the shareholder of reacquisition is determined by the values

for p, a and b. The actual effect on the shareholder is a function of two relationships; (i) the relationships between p (the price paid for the shares), and $\frac{V}{S}$ (the value of the shares before reacquisition), and (ii) the relationship between a (the fraction of total shares outstanding repurchased by the corporation) and b (the fraction of shares the individual holds and does not sell).

There is no change in the value of the shareholder's interest if the price paid per share is equal to the value of the share -- if $p = \frac{V}{S}$. Equally significant, it can be shown that there is no change in the value of that interest if the percentage of the holding sold by the shareholder is equal to the percentage of total shares outstanding repurchased -- if $a = (1-b)$. This is the case of proportional reacquisition.

What if neither of these conditions exist? It is shown in part II of this appendix that if

$p > \frac{V}{S}$, then $\Delta I > o$ if $(1-b) > a$, and
$\Delta I < o$ if $(1-b) < a$. Further,

if $p < \frac{V}{S}$, then $\Delta I < o$ if $(1-b) > a$, and
$\Delta I > o$ if $(1-b) < a$.

It can alternately be shown that

if $(1-b) > a$, then $\Delta I > o$ if $p > \frac{V}{S}$, and
$\Delta I < o$ if $p < \frac{V}{S}$. Further,

if $(1-b) < a$, then $\Delta I > o$ if $p < \frac{V}{S}$, and
$\Delta I < o$ if $p < \frac{V}{S}$.

These relationships can be demonstrated in matrix form and are summarized below:

	$a<(1-b)$	$a=(1-b)$	$a>(1-b)$
$p<\frac{V}{S}$	$\Delta I>o$	$\Delta I=o$	$\Delta I<o$
$p=\frac{V}{S}$	$\Delta I=o$	$\Delta I=o$	$\Delta I=o$
$p>\frac{V}{S}$	$\Delta I<o$	$\Delta I=o$	$\Delta I>o$

A review of the matrix indicates that if either (i) the price of the shares is equal to the value of the shares (in the matrix, the column $P=\frac{V}{S}$ or (ii) if the reacquisition was proportional [where a = (1 - b)] then there is no change in the value of the shareholder's interest, regardless of the values for the other variables. If neither of these conditions hold, then the change is the product of the interrelation between the values a, b, p, and $\frac{V}{S}$.

Tables I and II which follow are useful in demonstrating the effects of these variables.

The data on which the Tables are based can be expressed as follows:

Tables I and II

V	$5,000
S	1,000
s	100
p	$4, $5, $6
b	1.0, .75, .50, .25, & 0
a	Table I = .5 (500 shares); Table II = .25 (250 shares)

and certain columns in the Tables can be associated with these variables. Column one is equal to (1-b), Column six is equal to the change in the value of the interest, and the parts a, b, and c of each of the Tables represent the values for p. The Benefit/Detriment, or change in value of the interest, can be arrived at directly by use of the formula. Because the additional columns in the Table are helpful in developing an understanding of the practical significance of these variables, the tables are used as an explanatory device.

Tables I and II are based on the above assumed values relating to a corporation which reacquires some portion of its stock. Before the reacquisition, the value per share is

$$\frac{\$5,000}{1,000} = \frac{V}{S} = \$5 \text{ per share.}$$

The individual shareholder, before the reacquisition, holds 100 shares which constitutes a 10 per cent interest, and a value of $500 (100 shares x $5 per share).

In Table I, 500 shares (50 per cent of outstanding shares), and in

Table II, 250 shares (25 per cent of shares outstanding) are to be reacquired.

In both tables, shares are reacquired at prices of $5.00, $6.00 and $4.00 per share, which are, respectively, equal to, above, and below the value of the shares before reacquisition.

In both tables, and at each of these three prices, the shareholder is assumed to sell different parts of his holdings -- from 0 per cent to 100 per cent of his holdings. In each case, the percentage sold are so chosen as to show the effect of selling all shares, no shares, and a percentage of holdings equal to, greater than, and less than, the percentage of total outstanding shares reacquired by the corporation.

Column one, SHARES SOLD, indicates the number of shares sold by the shareholder. Since the total holding is 100 shares, this figure is also the percentage of shares sold by the shareholder. (This percentage figure is later compared to the percentage of total outstanding shares reacquired.)

Column two, AMOUNT RECEIVED, is the amount received as consideration by the shareholder for the sale of his shares. It is the product of the number of shares sold (column one) and the price paid for the shares.

TABLE I

500 shares repurchased, 50% of total shares outstanding

	(1) Shares Sold # & %	(2) Amount Received	(3) % Interest After	(4) Value of Interest After	(5) Total Value	(6) Benefit/ Detri-ment	(7) Gain/ Loss
Price paid per share $5.00 (a) Value of corporation after is $5,000 - (500 x $5) = $2,500	0	0	20	500	500	0	0
	25	125	15	375	500	0	0
	50	250	10	250	500	0	0
	75	375	5	125	500	0	0
	100	500	0	0	500	0	0
Price paid per share $6.00 (b) Value of corporation after is $5,000 - (500 x $6) = $2,000	0	0	20	400	400	(100)	0
	25	150	15	300	450	(50)	50
	50	300	10	200	500	0	100
	75	450	5	100	550	50	150
	100	600	0	0	600	100	200
Price paid per share $4.00 (c) Value of corporation after is $5,000 - (500 x $4) = $3,000	0	0	20	600	600	100	0
	25	100	15	450	550	50	(50)
	50	200	10	300	500	0	(100)
	75	300	5	150	450	(50)	(150)
	100	400	0	0	400	(100)	(200)

TABLE II

250 shares repurchased, 25% of total shares outstanding

	(1) Shares Sold # & %	(2) Amount Received	(3) % Interest After	(4) Value of Interest After	(5) Total Value	(6) Benefit/ Detri-ment	(7) Gain/ Loss
Price paid per share $5.00 (a) Value of corporation after is $5,000 - (250 x $5) = $3,750	0	0	13.4	500	500	0	0
	25	125	10.0	375	500	0	0
	50	250	6.7	250	500	0	0
	75	375	3.3	125	500	0	0
	100	500	0	0	500	0	0
Price paid per share $6.00 (b) Value of corporation after is $5,000 - (250 x $6) = $3,500	0	0	13.4	467	467	(33)	0
	25	150	10.0	350	500	0	33
	50	300	6.7	234	534	34	67
	75	450	3.3	117	567	67	100
	100	600	0	0	600	100	133
Price paid per share $4.00 (c) Value of corporation after is $5,000 - (250 x $4) = $4,000	0	0	13.4	533	533	33	0
	25	100	10.0	400	500	0	(33)
	50	200	6.7	266	466	(34)	(67)
	75	300	3.3	133	433	(67)	(100)
	100	400	0	0	400	(100)	(133)

Column three, PERCENTAGE INTEREST AFTER, is the percentage interest in the corporation represented by the remaining shares held, after the reacquisition. This percentage is a function of both the number of shares sold and the number of shares reacquired, and is calculated as

$$\frac{\text{number of shares retained}}{\text{number of shares o/s after reacquisition}}$$

For instance, in Table I, where 25 shares are sold, the INTEREST AFTER is 15 per cent, calculated as

$$\frac{\text{75 shares remaining (100-25 sold)}}{\text{500 shares outstanding (1000-500 reacquired)}}$$

Necessarily, these percentage interest figures are identical in all cases where 500 shares are reacquired (Table I), and similarly in respect to Table II, where 250 shares are reacquired.

Column four is the value of the shareholders' interest as represented by the shares retained after the reacquisition. This figure is the product of the percentage interest (column three) and the value of the corporation after the reacquisition, given to the left of the table. Thus, in Table I, price of $5.00, the value "after" is given at $2,500. This figure is the original value of $5,000 (given) less the $2,500 disbursed in reacquiring 500 shares at $5.00 per share. Since the price changes in each case, the "value after" will also change, and

the value of a given interest will change accordingly. [This could be calculated alternately as the product of the value per share "after" and the number of shares retained.]

Column five, TOTAL VALUE, is the sum of the "amount received" (Column 2) and the "value of interest" (Column 4). This is the sum of the value of the interest retained. Thus, by comparing this "TOTAL VALUE" to the value of the holding before the reacquisition, the benefit or detrement to the shareholder because of the reacquisition by the corporation can be determined.

BENEFIT/DETRIMENT, in column six, is the difference between the TOTAL VALUE and the original value of the shareholding, $500 (100 shares at $5.00). Thus, if the total value is greater than $500, the shareholder has benefitted; if less than $500, his position has been impaired. It should be noted that, as these tables are constructed, the resulting BENEFIT/DETRIMENT, in a given reacquisition, is a function of all of the following variables:

(1) the price paid for the shares:
    $5.00 per share, equal to share value
    $6.00 per share, greater than share value
    $4.00 per share, less than share value
(2) the number of shares sold by the shareholder:
    zero shares,
    25 shares, equal to 25% of the shares held
    50 shares, equal to 50% of the shares held

75 shares, equal to 75% of the shares held

100 shares, equal to 100% of the shares held

(3) the number of shares reacquired:

500 shares, 50% of shares outstanding

250 shares, 25% of shares outstanding

Column seven, GAIN/LOSS, measures the cumulative gain or loss incurred by the shareholder by having sold the various amounts (percentages) of stock as against having sold none of his shares, in the various assumed circumstances. For example, in Table I, at a price of $6.00 per share, the shareholder gained $50 by having sold 25 shares rather than having sold none, and gained $200 by having sold all, rather than none. A further example, in Table I, at a price of $4.00 per share, a loss of $50 would be incurred because 25 shares were sold; this would have been avoided by selling no shares. Note, however, the relationship between this GAIN/LOSS figure and BENEFIT/DETRIMENT figure. On the same line (Table I, price $4.00, 25 shares sold), the loss by selling is $50 -- at the same time the benefit is still $50. This suggests correctly that a benefit of $100 -- rather than $50 -- would have been enjoyed by selling no shares.

The formula can be used to derive directly the change in the value of the shareholders' interest. For example, to calculate this change in re line 2 of part (b) of Table I; there the values are:

$$V = 5{,}000$$

$$S = 1{,}000$$

$$s = 100$$

$$p = 6$$

$$b = .75$$

$$a = .5$$

$$I = \left[\frac{V-apS}{(1-a)S} \right] bs + ps\,(1-b) - s\frac{V}{S}$$

substituting

$$\Delta I = \left[\frac{5000-(.5)(6)(1000)}{(1-.5)(1000)} \right] (.75)(100) + 6(100)(1-.75) - 100\left(\frac{5000}{1000}\right)$$

$$= \left[\frac{5000-3000}{500} \right] 75 + 150 - 500$$

$$= \left[\frac{2000}{500} \right] 75 + 150 - 500$$

$$= 300 + 150 - 500$$

$\Delta I = -50$, which is in agreement with the table

The change in voting position of the individual shareholder as a result of the reacquisition is:

(1) $\Delta V = \frac{bs - (1-a)s}{(1-a)S}$, and the resulting voting position after the

(2) reacquisition is $\frac{bs}{(1-a)S}$, which is the equivalent of column three, the "% interest after," in Tables I and II. Formula (1) can be used (see Part II)

to prove that the effect on voting position will be zero, if the reacquisition is proportional, that is, if $a = (1-b)$.

It can be shown that if $a = 1-b$, then $V = 0$

$a > 1-b$, then $\Delta V > 0$, and

$a < 1-b$, then $\Delta V < 0$

This is demonstrated in Tables I and II. The column, % interest after, indicates the voting position which results from the sale of different fractions of the shares held by the shareholders. It will be seen that the percentage interest is unchanged from the original 10 per cent holding in every case where the fraction of shares sold is equal to the fraction of outstanding shares reacquired. Tables I and II are based on the assumed reacquisition of 50 per cent, and 25 per cent, respectively, of the outstanding shares. In each Table, where more than that percentage of shares originally held is sold, the resulting percentage interest is less than ten per cent, and where less than that percentage is sold, the percentage interest is greater than 10 per cent.

This can also be demonstrated by the use of formula (2). Choosing Table I, where $S = 1{,}000$

$s = 100$

$a = .5$, choosing three values for b, .75, .50, and .25, such that $(1-b) = .25, .50$, and .75 respectively, then the three cases represent

$1 - b = .25$, and $1 - b < a$

$$1 - b = .50, \text{ and } 1 - b = a$$

$$1 - b = .75, \text{ and } 1 - b > a$$

and represent lines 2, 3, and 4 in any part (a, b, or c) of the Table; substituting into (2):

$$\frac{bs}{(1-a)S} = \frac{.75(100)}{(1-.5)1000} = \frac{75}{500} = 15\%$$

$$= \frac{.50(100)}{500} = \frac{50}{500} = 10\%$$

$$= \frac{.25(100)}{500} = \frac{25}{500} = 5\%$$

which is in agreement with Column Three in the Table.

It follows that, in a given reacquisition, there will always be a change in the voting position of some, or all shareholders, unless the reacquisition is totally proportional to all shareholders.

Appendix IV Part II

Development of the formula, and demonstration of the effect on ΔI and ΔV of the relationships between a and 1-b, and between p and $\frac{V}{S}$.

Variable	Description	Limits
V	- the total value of the firm "before"	$V>0$
S	- number of shares outstanding "before"	$S>0$
s	- number of shares held by individual "before"	$s>0$
a	- fraction of total shares repurchased	$0\leq a\leq 1$
b	- fraction of shares individual holds and does not sell	$0\leq b\leq 1$
p	- repurchase price per share	$p>0$
ΔI	- the change in the value of the individual shareholder's interest, by virtue of the reacquisition	$-\infty<\Delta I<\infty$
ΔV	- the change in the voting position of the individual shareholder, by virtue of the reacquisition	$-\infty>\Delta V<\infty$

ΔI

The original value per share = $\frac{V}{S}$, (1)

the value per share of the shares retained = $\frac{V-apS}{(1-a)S}$ (2)

The value of the individual's interest before = $s\frac{V}{S}$ (3)

$$\text{after} = \left[\frac{V-apS}{(1-a)S}\right] bs + ps(1-b) \qquad (4)$$

$$\text{and } \Delta I = \frac{V-apS}{(1-a)S} \quad bs + ps(1-b) - \frac{sV}{S} . \qquad (5)$$

$\underline{\Delta V}$

Voting position

$$\text{before} = \frac{s}{S} \qquad (6)$$

$$\text{after} = \frac{bs}{(1-a)S} \text{ , and} \qquad (7)$$

$$\Delta V = \frac{bs-(1-a)s}{(1-a)S} \qquad (8)$$

Now in respect to the determination of the values for ΔI, with respect to the relations between a, 1-b and p, $\frac{V}{S}$, starting with equation (5)

$$\Delta I = \left[\frac{V-apS}{(1-a)S}\right] bs + ps(1-b) - s\frac{V}{S}$$

$$\Delta I = S\left[\frac{bV+bapS}{(1-a)S} + p(1-b)\frac{V}{S}\right] = S\left[\frac{bV}{(1-a)S} - \frac{V}{S} - \frac{bapS}{(1-a)S} + p(1-b)\right]$$

$$= S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) + \frac{-bap + p(1-b)(1-a)}{(1-a)}\right]$$

$$= S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) + \frac{p(-ab+1-a-b+ab)}{(1-a)}\right]$$

$$= S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) + \frac{p(1-a-b)}{(1-a)}\right] = S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) + p\left(\frac{1-a}{1-a} - \frac{b}{1-a}\right)\right]$$

$$= S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) + p\left(1 - \frac{b}{1-a}\right)\right] = S\left[\frac{V}{S}\left(\frac{b}{1-a} - 1\right) - p\left(\frac{b}{1-a} - 1\right)\right]$$

$$= S\left[\left(\frac{b}{1-a} - 1\right)\left(\frac{V}{S} - p\right)\right]$$

Since $S>0$, ΔI will be negative, zero or positive on the two terms $\left(\frac{b}{1-a} - 1\right)$ and $\left(\frac{V}{S} - p\right)$.

If either term is = 0, then $\Delta I=0$

If both terms are >0, or both <0, then $\Delta I>0$

If one term is >0 and the other <0, the $\Delta I<0$

Then $(\frac{b}{1-a} - 1) < 0$, if $a<1-b$,

$(\frac{b}{1-a} - 1) = 0$ if $a = 1-b$

$(\frac{b}{1-a} - 1) > 0$, if $a>1-b$.

Since $V>0$, $S>0$, it follows that

$(\frac{V}{S} - p) < 0$, if $p>\frac{V}{S}$,

$(\frac{V}{S} - p) = 0$, if $p=\frac{V}{S}$,

$(\frac{V}{S} - p) > 0$, if $p<\frac{V}{S}$.

Thus, there are nine possible situations, summarized below:

	$a<1-b$	$a=1-b$	$a>1-b$
$p<\frac{V}{S}$	$\Delta I>0$	$\Delta I=0$	$\Delta I<0$
$p=\frac{V}{S}$	$\Delta I=0$	$\Delta I=0$	$\Delta I=0$
$p>\frac{V}{S}$	$\Delta I<0$	$\Delta I=0$	$\Delta I>0$

In respect to the determination of the values for ΔV with respect to the relationships between a, 1-b, starting

with equation (8),

$$\Delta V = \frac{bs - (1-a)s}{(1-a)S} \qquad (8)$$

$$= \frac{s}{S}\left(\frac{b-(1-a)}{1-a}\right) = \frac{s}{S}\left(\frac{b}{1-a} - \frac{1-a}{1-a}\right)$$

$$= \frac{s}{S}\left(\frac{b}{1-a} - 1\right)$$

Since $s>0$, $S>0$, then $\frac{s}{S}$ 0, and the term $\left(\frac{b}{1-a} - 1\right)$ will determine whether ΔV is negative, zero, or positive.

$\Delta V<0$, if $\left(\frac{b}{1-a} - 1\right)<0$, which can be simplified as follows:

$$\frac{b}{1-a} - 1<0,$$

$$\frac{b}{1-a} <1$$

Since $(1-a)\geq 0$, we can multiply both sides of the inequality by $b(1-a)$ without affecting the inequality.

$$b<1-a$$

$$a<1-b$$

Similarly,

$\Delta V=0$, if $\left(\frac{b}{1-a} - 1\right) = 0$, which can be simplified to $a=1-b$.

$\Delta V>0$, if $\left(\frac{b}{1-a} - 1\right)>0$, which can be simplified to give $a>1-b$.

To summarize:

$V<0$, if $a<1-b$,

$V=0$, if $a=1-b$,

$V>0$, if $a>1-b$.

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