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Illusory Aspect of Corporate Contract to Repurchase Stock

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Committee on Stock List of the New York Stock Exchange would require before listing a preferred stock that the stock disclose just what its preferences are in excess profits. To date the problem has never arisen on the New York Stock Exchange and the views of the members and traders of the Exchange cannot be ascertained.

The question may still be considered an open one.[30] The Virginia court sums up the problem by saying:

> "I do not think that either rule can be gathered from the decisions of the courts as a maxim of the law applicable to all cases. It may be that in some cases the failure to make any provision as to participating in excess dividends would naturally be construed as granting such participation, while in other cases the failure to make such provisions would be held as a denial of participation. That question must be decided in the light of all the language of the contract, giving effect to every provision in it, and construing it in the light of the circumstances in which the parties stood."[31]

SAMUEL LEVINE.

ILLUSORY ASPECT OF CORPORATE CONTRACT TO REPURCHASE STOCK.

The New York Penal Law[1] declares, "A director of a stock corporation who concurs in any vote or act of the directors of such corporation, or any of them by which it is intended * * * 5. to apply any portion of the funds of such corporation except surplus, directly or indirectly to the purchase of shares of its own stock is guilty of a misdemeanor". The Penal Law is naturally construed as permitting a corporation to purchase its own shares from surplus.[2] A majority

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ferred were entitled to receive seven per cent cumulative dividends and the common stock to receive annual dividends of seven per cent, any surplus to be distributed pro rata to preferred and common. The question raised was whether the common shareholders were entitled to cumulative dividends before the two classes became entitled to participate equally. *Held,* that the contract does not so provide, citing Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918). But in Pennsylvania the rule had been laid down that the preferred stockholders share with the common in excess profits in the absence of any provision negativing such intent. In Lockwood v. General Abrasive Co. the certificate of incorporation expressly provided for such participation. The case merely holds, therefore, that the preferred are entitled to all arrearages (being cumulative) before the common get their annual dividend and then both classes share.

[30] 1 COOK, CORPORATIONS (6th ed.) § 269.

[31] Lyman v. Southern Ry., 149 Va. 274, 141 S. E. 240 (1928).

[1] PENAL LAW c. 40, § 664.

[2] Grasselli Chemical Co. v. Aetna Explosive Co., 258 Fed. 66 (S. D. N. Y. 1918); *In re* Fechheimer Fishel Co., 212 Fed. 357 (C. C. A. 2d, 1914); Richards v. Weiner, 207 N. Y. 59, 100 N. E. 592 (1912); Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 378 (1929).

of the states do not insert this restriction and hold that a corporation may purchase its own stock if there is no statutory or charter prohibition, and if done in good faith without injury to creditors, even though no express statutory or charter authorization exists.[3] The General Corporation Law [4] by stating that the "charter of every corporation shall be subject to alteration, suspension and repeal in discretion of the legislature" makes the Penal Law an integral part of every corporate charter, and charges contracting parties with notice of Penal Statute. Because of the provision in the Penal Law—agreements effected by a corporation to repurchase its own stock at a future date have been looked down upon by some New York courts and held as *not mutually binding and as lacking in consideration.*[5] On the other hand, other New York courts [6] have held such contracts *valid in their inception.*

In *Topken, Loring and Schwartz* v. *Schwartz* [7]—a controversial New York case,—a contract was entered into between the corporation and its employee, whereby upon the termination of his employment, the employee was to sell his stock-holdings to the corporation. It was held that the contract lacked mutuality of obligation.[8] The corporation's premise was conditioned on its having a surplus on hand at the end of the employment,—a surplus sufficient to pay the book-value, and since the condition of that promise was within its control, its *promise was illusory and furnished no consideration for the employee's promise.*

What is the nature of an illusory promise? What is its effect on repurchase agreements? The restatement [9] holds that a promise which according to its terms leaves the condition to performance of the promise *wholly within the control of the promisor* and makes performance optional with him is, in fact, no promise although often called an illusory promise. At another point the restatement sets

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[3] Iowa Lumber Co. v. Foster, 49 Iowa 25, 31 Am. Rep. 140 (1878); Barrett v. Webster Lumber Co., 275 Mass. 302, 175 N. E. 765 (1931); O'Brien Mercantile Co. v. Bay Lake Fruit Growers, 178 Minn. 179, 226 N. W. 513 (1929); Cole v. Cole Realty Co., 169 Mich. 347, 135 N. W. 329 (1912); Davis v. Montana Auto Finance Corp., 86 Mont. 500, 284 Pac. 267 (1930); Fremont Carriage Co. v. Thomsen, 65 Neb. 370, 91 N. W. 376 (1902); Wolf v. Excelsior Automatic Scale Co., 270 Pa. 547, 113 Atl. 569 (1921); Kennerly v. Columbia Chemical Corp., 137 Va. 240, 119 S. E. 265 (1923); Gelchrist v. Highfield, 140 Wis. 476, 123 N. W. 102 (1909).

[4] GEN. CORP. L. of N. Y., art. II, § 5.

[5] Topken, Loring and Schwartz, Inc. v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1929); Norwalk v. Marcus, 261 N. Y. 615, 185 N. E. 761 (1933).

[6] Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 378 (1929); *In re* Fechheimer Fishel Co., 212 Fed. 357 (C. C. A. 2d, 1914).

[7] 249 N. Y. 206, 163 N. E. 735 (1929).

[8] WHITNEY, CONTRACTS (2d ed. 1934) § 49, "Mutuality of obligation means that each party must be bound at least to some extent, they do not need to be bound to the same or equal extent".

[9] RESTATEMENT, CONTRACTS § 2 (b), "An apparent promise which according to its terms makes performance optional with the promisor whatever may happen, or whatever course of conduct in other respects he may pursue, is in fact no promise, although often called an illusory promise."

forth[10] "A conditional promise in which the promisor does not control the condition may be sufficient consideration for a counter-promise and though the condition of the promise may never happen, and in that event the promisor will not violate his promise if he does nothing, this alone will not prevent the promise from being sufficient consideration." [11] It is well established that an illusory promise constitutes insufficient consideration,[12] but *not every conditional promise is an illusory one.* A conditional promise is not illusory unless the condition is within the arbitrary control of the promisor.[13] The validity of a bilateral contract is neither affected by the condition that one of the parties may terminate the contract upon the happening of contingencies,[14] nor is it affected by a promise, the performance of which is entirely conditioned upon the happening of a future event.[15]

The *Topken* case attempted to classify the repurchase agreements as illusory and void in their inception,—illusory because it is allegedly within the sole discretion of the corporation (or of the directors as representatives of the corporation) whether or not to perform. It is inferred, therefore, that the corporation could distribute its surplus before the purchase date to *avoid* such a contract. Where no surplus exists, the corporation can not purchase.[16] In the instant case,[17] no surplus existed at the purchase date. Before the decision in this case the law, as to the validity of the contract, appears to have been settled in *Re Fechheimer, Fishel Co.*[18] "A corporation's contract to pur-

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[10] RESTATEMENT, CONTRACTS § 77 (b).

[11] 1 WILLISTON, CONTRACTS (1st ed. 1924) 215 (In regards sufficient consideration in a bilateral contract, "Mutual promises in each of which the promisor undertakes some act or forbearance that will be, or apparently may be, detrimental to the promisor or beneficial to the promisee and neither of which is rendered void by any rule of law, other than that relating to consideration, are sufficient consideration for one another").

[12] Cold Blast Transport Co. v. Kansas City Bolt Co., 114 Fed. 77 (C. C. A. 8th, 1902); Higbie v. Rust, 211 Ill. 333, 71 N. E. 1010 (1904); Burgess Fibre Co. v. Broonefield, 180 Mass. 283, 62 N. E. 367 (1902); Gross v. Stampler, 165 N. Y. Supp. 214 (1st Dept. 1917); ANSON, CONTRACTS (Turck ed. 130) ("Although courts of law will not inquire into the adequacy of consideration, they will insist that it should not be illusory, or unreal").

[13] See Nassau Supply Co. v. Ice Service Co., 252 N. Y. 277, 169 N. E. 383 (1929), and cases cited in note 12, *supra.* It should be noted that these cases as well as RESTATEMENT § 77b (see note 10, *supra*) demand that *in an illusory* contract, the condition to performance of the promise must be *wholly within control of the promisor.*

[14] Keystone Steel and Wire Co. v. Pierce Oil Co., 17 F. (2d) 476 (C. C. A. 7th, 1927); Wood and Co. v. Van Deursen, 122 Okla. 19, 250 Pac. 524 (1926).

[15] Beaumont Traction Co. v. Texarkana Ry., 103 Tex. 49, 123 S. W. 124 (1900); and see 1 WILLISTON, CONTRACTS (Rev. ed. 1936) § 104, which holds that the decisive factor in determining whether a promise is illusory is whether the event upon which performance is conditioned is within the arbitrary control of the promisor.

[16] PENAL LAW c. 40, § 664.

[17] Topken, Loring and Schwartz v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1929).

[18] 212 Fed. 357 (C. C. A. 2d, 1914).

chase its own stock, *though valid in its inception,* can not be enforced unless a surplus exists where payment is due."

Shortly following the *Topken* decision, the same court was confronted with *Cross* v. *Beguelin.*[19] A corporation had contracted to purchase a large block of its own stock from the plaintiff, out of its then existing surplus. Before the installment payments had been completed, the corporation became financially embarrassed and turned its claims over to a creditors' committee. Plaintiff sued for specific performance. In its opinion the court said: "When made, *the agreement with Ferdinand Cross was valid*"[20] * * * Although plaintiff's claim would not have been enforced against the corporation, since it had no surplus, *it is enforceable against the creditors' committee.* The case is in apparent conflict with the court's earlier decison in the *Topken* case and places limitations thereon. The later decision no longer classified the purchase agreements as illusory (which classification would of necessity *void* the contract) but held the agreement *valid in its inception.*

If a contract be not binding, it can not be the basis of a subsequent valid claim, as it was in the *Cross* case.[21]

The Pennsylvania Business Corporation Law[22] empowers a corporation "To purchase, take, receive or otherwise acquire, its own stock * * * *except that no such purchase* or acquisition shall be made at a time where the net assets of the corporation are less than its stated capital, or which would reduce its net assets below its stated capital."[23] In a case[24] under the Pennsylvania Business Corporation Law—a corporation entered into an agreement with an employee for the sale to him of 100 shares at par. It was mutually agreed that upon termination of his employment—or within 30 days thereafter—the corporation would repurchase at par. The agreement was sustained as valid—the court apparently deciding that *the contract was not illusory and was not lacking in mutuality of obligation*—and, as a surplus existed on the repurchase date, the corporation was compelled to pay par value plus certain accretions and dividends.[25]

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[19] 252 N. Y. 262, 169 N. E. 378 (1929).

[20] 252 N. Y. 262, 265, 169 N. E. 378, 379 (1929).

[21] See (1930) 43 HARV. L. REV. 830, "The court in the instant case (Cross v. Beguelin) did not mention the Topken case in this regard nor did it base recovery on principles of quasi-contract. This would seem to indicate that the earlier decision has been pared down to a holding that equity will not grant the corporation specific performance against a stockholder *who has received nothing but a promise which he may not be able to enforce.*" (Italics ours.)

[22] Art. III, § 302, subd. 7.

[23] Compare this with the N. Y. PENAL LAW c. 40, § 664. Both statutes have the effect of limiting the repurchase of a corporation's own stock to instances where a surplus exists.

[24] Revloc Supply Co. v. Troxell, 281 Pa. 424, 126 Atl. 774 (1924).

[25] It is well to bear in mind that this decision was reached in a state having a statute (see note 21, *supra*) similar to the one governing in New York (see note 11, *supra*).

The principal New York cases here discussed [26] are in accord that "The assets of a corporation constitute a trust fund for the benefit of the creditors", consequently a purchase of corporate stock out of capital is said to be illegal because in violation of the rights of corporate creditors.[27] The Penal Law constitutes the bar to such transactions, but the creditors have no right to complain so long as the capital is kept intact.[28] Undoubtedly the result reached in the *Topken* case is a fair and just one—for had the court decreed specific performance—the defendant, employee, would have received nothing in return for his shares. (The shares had no book value.) But the deductions and methods used to reach that decision are causing unnecessary confusion and bar a desirable type of contract between corporation and employee.[29] The case is open to criticism on two grounds:

1. It was dicta to declare the contract illusory and lacking in mutuality.
2. The contract was not illusory.

(1) As was previously noted, the Penal Law permits the repurchase of stock out of surplus, and contracts to so repurchase are valid.[30] As no surplus existed on the repurchase date, the court should have decided the case on that issue and avoided the contract as of that date—as other courts have done under similar circumstances.[31] Assuming that the contract had stated, as a condition, that it be unenforceable if no surplus existed on the repurchase date, the result would not be changed. The condition would merely be stating that which the Penal Statute injects into all such contracts—and an illegal intent will not here be presumed.[32]

(2) The court's premise was that the contract was illusory—that it left to the discretion of the corporation whether or not to per-

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[26] Topken, Loring and Schwartz v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1929); Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 378 (1929).

[27] See Note (1913) 13 Col. L. Rev. 148.

[28] See Note (1914) 14 Col. L. Rev. 451, "Creditors have no right to complain so long as the capital on which they are presumed to rely is kept intact." In discussing Fechheimer Fishel Co., 212 Fed. 257 (C. C. A. 2d, 1914) the note stated, "Since the purchase *did not encroach upon the capital* at the time it was made, it would seem that a valid debt was created." (Italics ours.)

[29] The majority rule through the forty-eight states is that a corporation may purchase its own stock if "in good faith and without intent to injure creditors." See Current Digest, Corporations § 376, and cases cited in note 2, *supra.*

[30] Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 278 (1929); Richards v. Weiner, 207 N. Y. 59, 100 N. E. 592 (1912); *In re* Fechheimer Fishel Co., 212 Fed. 357 (C. C. A. 2d, 1914).

[31] See note 21, *supra;* and see (1929) 29 Col. L. Rev. 356, "Although in holding the contract not specifically enforcible it was unnecessary for the court to decide that no action could be maintained at law." (Italics ours.)

[32] "On the contrary everything must be presumed to be legal until the contrary is proved", 118 App. Div. 490, 103 N. Y. Supp. 607 (3d Dept. 1907).

form.[33] (The decisive factor in determining whether a promise is illusory, is whether the event upon which performance is conditioned is within the arbitrary control of the promisor.)[34] Was performance discretionary? Was performance so within the control of the directors as to render their promise illusory?[35] We are not to infer any illegal intent to the directors.[36] There are also extra-promissory limitations on the promise (such as the economic impracticality of distributing surplus to avoid such a contract), which would seem adequate to prevent the promise from being illusory. Nor is the contract illusory under the definition set forth by the restatement[37] for the factor of arbitrary control is absent. To repeat, *the control of surplus by the directors is not so arbitrary as to render the promise illusory:* because of the economic impracticality and because there is no legal justification to assume that the directors will intentionally breach their contract. It would seem that at the most, the repurchase agreement is voidable *if no surplus exists at the repurchase date*— the existence of surplus being the condition to performance.[38]

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[33] The basis of the decision was that "one of the promises might or might not be good, the same as if a discretion were left to one of the parties to perform or not to perform", p. 211.

[34] 1 WILLISTON, CONTRACTS (Rev. ed. 1936) § 104; and see note 10, *supra.*

[35] This question naturally follows—as the only method by which the corporation could avoid its contract was to distribute its surplus so that none remained at repurchase date.

[36] Brown v. Little, Brown & Co., 269 Mass. 102, 168 N. E. 521 (1929) (Case also held, p. 205, "Directors must manage corporate affairs above their personal concerns with reasonable intelligence, as they occupy a fiduciary relation * * *").

[37] See notes 10, 11, *supra.*

[38] See Richards v. Weiner, 207 N. Y. 59, 100 N. E. 592 (1912) to the effect that where a corporation has failed to fulfill a contract to repurchase shares, the burden is upon the corporation of showing that no surplus existed out of which the purchase could be made. It is well to bear in mind at this point, that Pennsylvania, having a similar statute (see notes 22 and 23, *supra*) in a case somewhat similar to the *Topken* case (see *Revloc* case discussed in article) has held the contract enforceable and granted specific performance.