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Close Corporation Stock Repurchase Agreements

Today, hundreds of small, closely held corporations are trying to devise methods to release cash to their shareholders or to their shareholder’s estates, without imposing a heavy income tax burden upon either of them. One method of doing so is through the use of a corporation stock repurchase plan. The essence of such a plan is the sale of stock by a shareholder to the corporation in return for cash. The object is to provide the shareholder and his family with cash, instead of the non-marketable stock of a small corporation.

One method of achieving this result is to execute an agreement between each shareholder and the corporation, whereby the corporation agrees to buy, and the shareholder agrees to sell his stock to the corporation upon the occurrence of certain contingencies, such as death or termination of employment. The agreement gives the corporation the option or duty to purchase the stock at an agreed price, and binds the shareholder to sell to the corporation, or to transfer his stock subject to the corporation’s option.

Another method used is an agreement whereby the shareholders individually contract to buy out the interest of any shareholder who dies, or terminates his employment with the corporation. However, such a plan may be impractical where the cash necessary to buy out a shareholder’s interest is to be provided by the proceeds from an insurance policy on the shareholder’s life, taken out by the other shareholders. That is, where the largest interest to be purchased is owned by an older individual, the rates for insurance on his life may be excessive in relation to the income of younger, minority shareholders, who would pay the premiums on the policy. The most important factor, regardless of the age of the insured, is that the premiums must be paid with after-tax dollars; that is, money left after the shareholder has paid his personal income tax.

This note is limited to stock repurchase plans to which the “close” corporation is a party. Such a corporation is not of the large, publicly owned variety like General Motors or United States Steel, but one with a limited number of shareholders. These shareholders are generally, though not always, the officer-employees of the corporation.

Advantages of the Plans

The primary advantage of a stock repurchase plan to the remaining shareholders is solidification of control without a costly battle.

1. Because of the federal attribution rules, an agreement of this nature may be the only feasible type where most of the stock is owned by a family group. See note 11 infra, for a discussion of stock redemption and the family attribution rules found in INT. REV. CODE OF 1954, § 318.

2. For a more complete discussion, see Cunningham, Stock "Buy-Out" Plans: Selection and Drafting, 18 Md. L. Rev. 277 (1958). For comparison of the effect of payment of premiums by the corporation, see note 14 infra and accompanying text.
with the retiring shareholder or his heirs. Often, upon the death of a shareholder, his widow or his widow’s second husband will attempt to take the shareholder’s place in the business, although neither is qualified to do so. The remaining shareholders are usually reluctant to permit interference with the business, and may, therefore, seek to buy out the widow’s interest in the corporation. If a plan were not in effect at the death of the shareholder, these conflicting desires could precipitate a long and costly battle.

Further, key employees are more likely to remain with the corporation when a repurchase plan is in effect, because they are assured that the business will continue under the same management, even though one of the officer-shareholders should die. If these key employees own any stock in the corporation, they can look forward to a greater equity interest upon the death of a principal shareholder, because his stock will then be retired and the proportionate interest of the remaining shareholders will increase.3

The deceased shareholder is guaranteed that upon his death, his family will have ready cash instead of non-marketable corporation assets. If a repurchase plan were not in effect, the widow might find it impossible to sell her shares in the open market, and thus might be forced to sell to the surviving shareholders at an unreasonably low price, if they would purchase her stock at all.

A purchase plan guarantees that the corporation will buy her shares at a fair price. The price, or the method for determining the price,4 will generally be fair because the bargain is made when all the shareholders are alive and are uncertain who will die first. Thus, each party to the agreement will want the price to be fair to both the deceased shareholder and to the corporation because, at the time the agreement is made, none of the shareholders can know whether his shares will be sold.

If the widow were forced to keep the stock because she could not find a buyer at a fair price, she undoubtedly would realize little or no income. The stock in a close corporation generally does not pay more than nominal dividends because much of the income may be siphoned off in salaries to officer-shareholders in order to avoid dou-

3. The assured continuity of the business also makes it easier to obtain long-term bank loans. 4. A number of common methods, with many variations, are available to determine the price to be paid for the stock. (1) Book value can be used. The problem here is whether to include the value of insurance proceeds in the book value of the corporation. Suppose X and Y each own half of a $100,000 corporation and the corporation owns a $50,000 policy on the life of each. (a) When book value prior to death is used: if X dies his estate receives $50,000 cash and Y receives a corporation worth $100,000. (b) When book value after death is used: the insurance proceeds increase the value of the stock and X’s share is now worth about $75,000, but the corporation presumably only has $50,000 cash, so X’s estate may have to take $25,000 in notes. (2) Book value plus a stated premium per share. (3) Appraisal by independent parties. (4) Capitalization of earnings (e.g., 5 or 6 times the average earnings for the preceding five years). (5) Periodic negotiation of a new price by the parties, the sale price being the last negotiated price.
ble taxation, or may remain undistributed because the majority shareholders are in a high personal income tax bracket and do not want additional income taxable at high ordinary income rates. Thus, a repurchase plan guarantees the widow a ready buyer for her stock at a fair price and, where the stock is to be redeemed with the proceeds of an insurance policy on her husband's life, she is assured that the buyer will have the cash available to pay for her shares.

**Tax Aspects**

Aside from the above advantages to both the retiring and remaining shareholders, there are also important tax advantages inherent in a repurchase plan. Normally, it is very difficult to take cash out of a corporation without paying a heavy income tax because, generally, the favorable capital gains treatment is denied unless the stock is sold to an outsider, or unless all or most of it is sold back to the corporation. Because the stock usually has a limited market value, and because the shareholder is usually unwilling to give up his interest in the business, neither method is generally used during the life of the shareholder. If the shareholders attempt to redeem a portion of their stock for cash on a pro rata basis, the result will not be the expected capital gain treatment, but rather, a dividend taxable to each shareholder at ordinary income tax rates. This is true because the shareholders maintain the same proportionate control of the corporation as they had before the redemption.

Because it is so difficult to take cash out of a close corporation without relinquishing one's proportionate interest therein, or suffering a heavy tax burden, many shareholders prefer to retain their entire interest until death. There are great advantages to a shareholder's family if he permits his spouse to redeem the stock after his death, rather than converting it into cash during his lifetime.

When property, including stock, passes to a decedent's estate, it receives a tax basis equal to its fair market value at the date of the decedent's death (or the value within one year from that date, if so elected). Because of this step up in basis, when the stock is sold

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5. If money is paid in dividends, the corporation must first pay a tax on the earnings necessary to accumulate dividend money, INT. REV. CODE OF 1954, § 11. Then the individual must pay a tax at his personal tax rate on the money received as dividends, INT. REV. CODE OF 1954, § 61(a)(7). However, if the earnings are paid in the form of salaries, then the only tax payable is by the individual. Thus, the close corporation attempts to pay out as much of its income as possible in the form of salaries to officer-shareholders.


7. INT. REV. CODE OF 1954, § 302(b).

8. INT. REV. CODE OF 1954, § 302. It is very difficult to turn stock in for cash and still retain an interest in a small corporation without having the money received characterized as a dividend. In order to escape unfavorable ordinary income treatment, the redemption must be: (1) not essentially equivalent to a dividend, or (2) a substantially disproportionate redemption, or (3) a complete termination of the shareholder's interest. *Ibid.*

9. INT. REV. CODE OF 1954, §§ 1014(a), 2052.
by the shareholder's estate to the corporation, there will ordinarily be no gain and, therefore, no tax to the estate, because the stock presumably will be sold for its fair market value.\textsuperscript{10}

These tax advantages, when coupled with a stock repurchase plan which guarantees his widow a fair price for his stock, make it very desirable for a shareholder to retain his stock until death. He can be relatively assured that his widow will have, at his death, stock which she can convert into cash with little or no tax cost.

However, one must be aware of a danger which exists if the majority of the stock is owned by a family group. An individual is considered to own stock owned by or for his spouse, children, grandchildren, or parents.\textsuperscript{11} Thus, when stock is owned by a family group, any money received when the estate redeems the deceased's stock may be taxed as a dividend to the estate,\textsuperscript{12} because the estate is regarded as though it owned the stock held by other members of the deceased's family. In this situation a corporation repurchase plan will be impractical. However, the estate will, if it meets certain tests,\textsuperscript{13} be permitted to redeem enough stock to pay death taxes without incurring dividend treatment on the money received.

\textbf{Insurance Funding}

Favorable tax treatment and a guaranteed price are of little value to a widow if the corporation does not have cash available to purchase her stock. The widow will usually want the funds at once, not at some future date. One of the more common methods of assuring that the corporation will have immediate cash available to pay for the stock is through the use of life insurance to fund the stock repurchase plan.

To implement the repurchase plan, the corporation insures the life of each shareholder and designates itself beneficiary upon the death of the shareholder. When a shareholder dies, the cash proceeds then become available to repurchase his stock in the corporation. Such a plan permits the surviving shareholders to acquire the decedent's stock at a low yearly cost, the price being the premiums paid to insure the decedent's life.

A further advantage of funding with insurance is that corporation

\textsuperscript{10} The valuation of the stock set by the repurchase plan is acceptable for estate tax valuation purposes. Estate of Orville B. Littick, 31 T.C. 181 (1958).


\textsuperscript{13} INT. REV. CODE OF 1954, § 303.
funds may be used to pay the premiums on the policies. Even though the corporation is denied a business expense deduction for the premiums paid,\textsuperscript{14} it is still desirable to use corporate funds because a double tax is avoided. The premiums are paid in corporation dollars, not shareholder money which has been subjected to two taxes—one at the corporate level and one at the individual level.

Another desirable feature of insurance funding is that it creates no taxable income to either the corporation or the shareholders. When the insured dies, the proceeds of the policy on his life are not income to the beneficiary corporation.\textsuperscript{15} Nor are the premiums paid by the corporation taxable as a dividend to the shareholder where the corporation owns the policy, pays the premiums, and is the beneficiary of the policy.\textsuperscript{16} Thus, the advantages of insurance funding are twofold: an easy, pay-as-you-go method is provided to guarantee that there will be cash available to purchase the deceased shareholder's stock, and the money used to pay the premiums, though not allowable as a business deduction to the corporation, has still been subjected to only a single tax at the corporation level.\textsuperscript{17}

**ENFORCEABILITY OF AGREEMENTS**

*Mutuality of Obligation*

It is most disconcerting to find that doubt still exists as to whether a corporation repurchase agreement can be enforced. Yet, there is a decision\textsuperscript{18} which expressly holds that such agreements are not enforceable. The decision is based solely upon the contract theory of "mutuality."\textsuperscript{19}

Generally, if there is an attempt to create a bilateral contract in which the only duty demanded of one party is neither detrimental to him, nor beneficial to the other party, then the contract is not valid.\textsuperscript{20}

\textsuperscript{14} INT. REV. CODE OF 1954, § 264.

\textsuperscript{15} INT. REV. CODE OF 1954, § 101 (a).

\textsuperscript{16} Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957), acq., Rev. Rul. 59-184, 1959 INT. REV. BULL. NO. 21, at 8. For a full discussion, see Sneed, *A Defense of the Tax Court's Result in Prunier and Casale*, 43 CORNELL L.Q. 339 (1958); Lawthers, *Weakness in Casale Decision: Insolvency Could Destroy Benefit to Owner-Employee*, 5 J. TAXATION 342 (1956). Beware of the attempt of the Commissioner to assert that the money received is a constructive dividend to the remaining shareholders. Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958); Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958).

\textsuperscript{17} A further advantage is that the corporation can build up sufficient insurance reserves to purchase the stock without great fear of an accumulated earnings tax penalty. Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958).

\textsuperscript{18} Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928).

\textsuperscript{19} See 1 WILLISTON, CONTRACTS § 105 (3d ed. 1957) for a full discussion of the various types of mutuality and the confusion resulting from the improper use of the term.

\textsuperscript{20} Joliet Bottling Co. v. Joliet Citizens' Brewing Co., 254 Ill. 215, 98 N.E. 263 (1912); Blanchard v. Haber, 166 La. 1014, 118 So. 117 (1928); 1 WILLISTON, CONTRACTS § 104 (3d ed. 1957); RESTATEMENT, CONTRACTS § 80 (1932).
This is often characterized as lack of "mutuality of obligation." In fact, the problem is one of consideration. If one party can fully escape performance of his duties under the contract without incurring liability, then there is no consideration and, hence, no contract. It should be noted, however, that when the obligation undertaken by one party is merely not commensurate with that undertaken by the other, the contract is valid because both parties must still perform their promised duties. Thus, if the performance of a promise is conditioned upon the occurrence of an event, the contract is valid, unless the condition is within the arbitrary control of the promisor.

New York Decisions

The doctrine of "mutuality" was invoked by the highest court of New York in Topken, Loring & Swartz, Incorporated v. Schwartz, to hold invalid a stock repurchase agreement. The New York Penal Code forbids a director of a corporation to apply any portion of its funds, except funds from surplus, to the purchase of its own shares. In Topken, it was immaterial to the court whether the corporation had surplus at the time of the execution of the repurchase agreement. The court reasoned that it was possible that the corporation would have no surplus at the time of the repurchase. Were this true, then the corporation would be unable to perform its promise in view of the fact that the repurchase could, lawfully, only be funded from surplus. Thus, because the agreement might not be binding on the corporation, the court held that it was not binding on the shareholder. Hence, the contract was void ab initio. Inasmuch as this decision, rendered by the highest court of the state, stands unreversed, it apparently is still the law in New York. The court did not take into consideration the fact that a contract may be valid even though the promise of one party be conditioned upon the occurrence or non-occurrence of an event. The decision has been criticized and side-stepped, but not overruled.

The Topken rule may have been modified by a later decision of

22. WILLISTON, CONTRACTS § 103 (3d ed. 1957).
23. 249 N.Y. 206, 163 N.E. 735 (1928).
24. City of Camden v. South Jersey Port Comm'n, 2 N.J. Super. 278, 63 A.2d 552 (1948), modified on other grounds, 4 N.J. 357, 73 A.2d 55 (1950); WILLISTON, CONTRACTS § 103 (3d ed. 1957); RESTATEMENT, CONTRACTS § 77 (1932). An argument might be made that here the promisor (corporation) can arbitrarily determine if there will be a surplus at the time the agreement is to be enforced. However, it can be argued that the corporation cannot arbitrarily do so because it must act in good faith. The reasoning of the court did not cover this point.
the same New York court in Cross v. Beguelin. Here, the court held an agreement to repurchase stock valid at its inception, where surplus was available when the contract was made. The corporation in this case was in financial difficulty at the time for performance and had been put into the hands of a creditor's committee. The committee had paid all existing creditor's claims and still had money available. There were two claims against this surplus: one by a shareholder, Cross, who was a party to the repurchase agreement; and a second, by officers who had earned salaries after the repurchase agreement had been executed. The surplus was insufficient to meet both claims. The court held that Cross was entitled to the surplus because the officers had notice of the corporation's prior indebtedness to Cross when they extended credit to the corporation in the form of services. Although the court found that the repurchase agreement was valid when made, the holding of this decision does not overrule Topken, because the corporation was not a party to this action.

Later New York courts have made every effort to avoid the holding of the Topken case. In the leading case, Greater New York Carpet House, Incorporated v. Herschmann, the court implied consideration from the fact that the corporation agreed to pay premiums on a life insurance policy, the proceeds of which were to be used to redeem the shareholder's stock. The shareholder's widow, in reliance upon the Topken decision, refused to sell the stock to the corporation. In a suit by the corporation, the contract was held valid because of the implied consideration. The court stated that lack of sufficient funds in surplus at the time of repurchase was available only as a defense to the enforcement of the contract. Another court held immaterial the fact that surplus was not available at the time of the execution of the repurchase agreement. Their sole concern was that it be available when payment for the shares became due. In still another case wherein mutuality was an issue, the court disregarded the mutuality problem because no proof was offered that the corporation did not have a surplus at the time of performance. In short, no New York court has followed the Topken case. The various means and methods of reasoning used to avoid its impact have seriously impaired the Topken decision's value as precedent.

Ohio Decisions

In Ohio, the mutuality problem has never been raised in a stock repurchase case. In Fuchs v. United Motor Stage Company, where

32. 135 Ohio St. 509, 21 N.E.2d 669 (1939).
the defendant's duty was to sell all of a particular commodity that was required by the plaintiff, the court held:

So long as there is consideration for the obligation of one party to purchase merchandise from another, it is not always essential that there be mutuality of obligation between them . . . .

The *Fuchs* case is analogous to a stock repurchase situation in that the vendee's obligation in the *Fuchs* case was conditioned upon his requiring "something," and, in the stock repurchase situation, the corporation's obligation to purchase is conditioned upon its having sufficient surplus. The holding of the *Fuchs* case can be used as the basis for an argument that, so long as there is consideration, a conditional contract is valid in Ohio.

**Impairment of Capital — Insolvency**

Today, most states do not hold a repurchase agreement void at the time it is made on the ground of lack of "mutuality of obligation." However, if at the time for repurchase, the corporation is insolvent, many states refuse to enforce the agreement because to do so would prejudice creditors. If to allow the repurchase would impair capital, some states refuse to enforce the agreement because shareholders, as well as creditors, might be prejudiced. Some states permit the repurchase only out of surplus (with various definitions of surplus), or only where sufficient assets remain to pay corporate debts. Others allow repurchase only as specifically provided for in their statutes.

**The Ohio View**

The early Ohio courts felt that it was an ultra vires act for a corporation to purchase its own stock. There was an exception to this rule when stock was accepted by the corporation in repayment of a debt. In a 1910 case, this theory was discarded, and a pur-

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34. See note 24 supra.
chase by a corporation was allowed. The court held that the defense of ultra vires did not apply because the contract was, at most, voidable. Twenty years later, in Humphrey v. Koogler, repurchase contracts were held valid. The plaintiff was permitted to recover on the corporation’s note, given in exchange for the stock, even though the defendant asserted that the purchase was invalid. In Squire v. Rafferty, the plaintiff was denied the right to enforce a repurchase agreement after the corporation had become insolvent. However, the court recognized that:

The right to enforce such provision [repurchase agreement] is not denied as between the parties where rights of creditors have not intervened. It is this intervention that affects enforcement.

In Wildermuth v. Lorain Coal and Dock Company, the corporation had a sinking fund which was to be used to redeem preferred shares. It attempted to use this fund for other purposes, and to deny any liability to the preferred shareholders. The court held that the corporation could not do so. It held that only the grounds permitted by the stock repurchase statute then in effect were available to deny the validity of the repurchase agreement. Although the present statute is different, the rule of the case, that only the statutory grounds can be used to prevent the enforcement of a stock repurchase agreement, still applies. In another case, a repurchase agreement was enforced without reference to the validity of the contract.

Although Ohio does not question the validity of a corporate agreement to purchase its own stock, by statute, it limits the situa-

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42. 131 Ohio St. 156, 2 N.E.2d 255 (1936).
43. Id. at 164, 2 N.E.2d at 259.
44. 138 Ohio St. 1, 32 N.E.2d 413 (1941).
45. The applicable statutory provision was Ohio General Code § 8623-41: "Where there is reasonable ground for believing that such purchase would leave the corporation with assets of less value than the aggregate of its liabilities over its assets."
46. OHIO REV. CODE § 1701.35 (B) has changed the test to include insolvency.
48. OHIO REV. CODE § 1701.35 (A): "(A) A corporation by its directors may purchase shares of any class issued by it, in any of the following instances: (1) When the articles authorize the redemption of such shares and do not prohibit such purchase; (2) To collect or compromise a debt, claim, or controversy in good faith; (3) From a subscriber whose shares have not been paid for in full, or in settlement or compromise of a subscription; (4) For offering and sale, or the grant of options with respect thereto, to any or all of the employees of the corporation or of subsidiary corporations... under any plan adopted or to be adopted by the directors for that purpose; (5) From a person who has purchased such shares from the corporation under an agreement reserving to the corporation the right to repurchase or obligating it to repurchase; (6) To avoid the issuance of or to eliminate fractional shares; (7) When the articles in substance provide that the corporation shall have a right to repurchase if and when any shareholder desires to, or on the happening of any event is required to, sell such shares;
tions in which a repurchase may be made, as for example, "when authorized by the articles, or by the shareholders . . ."49 However, by statute, even if a repurchase agreement were valid by these criteria, enforcement of the agreement may still be denied if the corporation is insolvent, or if to allow the repurchase would render the corporation insolvent, or cause its capital to become impaired.

In Ohio, in order to determine whether capital would be impaired by the repurchase of corporate stock, it is necessary to understand what constitutes the corporation's capital accounts. The basic account is stated capital, which need only contain a minimum of $500, or, if par value shares are issued, a sum equal to their aggregate par value if greater than $500.51 The Ohio corporation also has three surplus accounts: capital surplus, earned surplus, and capital surplus arising from appreciated assets.52 The directors or the shareholders may transfer funds from one surplus account to another, or to stated capital.53 However, only the shareholders may reduce stated capital,54 but even then, it may not be reduced below the statutory minimum requirement ($500 or the aggregate value of par value shares, whichever is the greater).55

When a corporation purchases its own shares, it must reduce stated capital to the extent of the stated capital represented by the shares. The balance of the purchase price, if any, is charged to surplus.56 An impairment of capital results when the value of the corporation's assets is less than its liabilities plus stated capital.57 A repurchase agreement that will impair capital is unenforceable in Ohio.

A stock redemption may usually be planned in advance to insure that there will be enough surplus available so that capital will not be impaired. Stated capital may, within limits, be reduced to increase surplus, or the directors may create additional surplus by writing up the appreciated physical assets. Unlike the rule in regard to payment of dividends, there is no statutory prohibition against using

(8) From a shareholder who by reason of dissent is entitled to be paid the fair cash value of his shares; (9) When authorized by the articles, or by the shareholders at a meeting called for such purpose, by the affirmative vote of the holders of two-thirds of the shares of each class, regardless of limitations or restrictions in the articles on the voting rights of the shares of any such class, or, if the articles so provide or permit, a greater or lesser proportion, but not less than a majority, of the shares of any class."

49. OHIO REV. CODE § 1701.35 (A) (9).
50. OHIO REV. CODE § 1701.35 (B).
51. OHIO REV. CODE § 1701.30 (A).
52. OHIO REV. CODE §§ 1701.32 (A), (D).
53. OHIO REV. CODE §§ 1701.32 (B), (E). However, surplus arising from unrealized appreciation of assets may not be used to write off a deficit in earned surplus. OHIO REV. CODE § 1701.32 (F).
54. OHIO REV. CODE § 1701.31 (B).
55. OHIO REV. CODE § 1701.31.
56. OHIO REV. CODE § 1701.31 (A).
57. OHIO REV. CODE § 1701.35 (B). Impairment is viewed after the repurchase. Suppose
surplus created by unrealized appreciation of assets to offset a stock repurchase.\textsuperscript{58} Thus, with planning, it would be unlikely that a corporation could not fulfill a stock repurchase agreement on the basis that it would impair capital.\textsuperscript{59}

A corporation cannot purchase its own stock if it is "insolvent, or if there is reasonable ground to believe that by such purchase it would be rendered insolvent."\textsuperscript{60} The equity test of insolvency, not the legal test, was adopted by Ohio in 1955.\textsuperscript{61} Thus, a corporation might find itself insolvent even though it has assets of high value, if the assets are not readily marketable.

\begin{itemize}
\item the X Corporation has 100 shares of stock with a par value of $1.00 each. Before the repurchase, its balance sheet was:
\begin{center}
\begin{tabular}{ll}
\textbf{Assets} & \textbf{Liabilities} \\
80 & -0- \\
Capital Stock & 100 \\
Capital deficit & 20 \\
\hline
80 & 80
\end{tabular}
\end{center}

Now the corporation redeems 50 shares at 50 cents each, a price below par value. The balance sheet now shows:
\begin{center}
\begin{tabular}{ll}
\textbf{Assets} & \textbf{Liabilities} \\
55 & -0- \\
Capital Stock & 50 \\
Surplus & 5 \\
\hline
55 & 55
\end{tabular}
\end{center}

This action is legal; the repurchase of the 50 shares automatically reduces stated capital by the aggregate value of the shares. There is no impairment of capital after the purchase. But suppose the same corporation's balance sheet was:
\begin{center}
\begin{tabular}{ll}
\textbf{Assets} & \textbf{Liabilities} \\
120 & -0- \\
Capital Stock & 100 \\
Surplus & 20 \\
\hline
120 & 120
\end{tabular}
\end{center}

Now 50 shares of stock are repurchased for $2.00 per share, a price above par value. This would result in an impairment of capital because:
\begin{center}
\begin{tabular}{ll}
\textbf{Assets} & \textbf{Liabilities} \\
20 & -0- \\
Capital Stock & 50 \\
Deficit & 30 \\
\hline
20 & 20
\end{tabular}
\end{center}
\end{itemize}

\textsuperscript{58} Dividends may not be paid out of surplus arising from unrealized appreciation of assets. \textbf{OHIO REV. CODE} § 1701.33 (A).

\textsuperscript{59} The agreement should contain a clause obligating the remaining shareholders to do everything possible at the time of performance to make the contract enforceable. They should agree to cause the corporation to write up physical assets and/or to effect a reduction in stated capital so that the purchase will not impair capital.

\textsuperscript{60} \textbf{OHIO REV. CODE} § 1701.35 (B).

\textsuperscript{61} \textbf{OHIO REV. CODE} § 1701.01 (O). "Insolvent" means that the corporation is unable to pay its obligations as they become due in the usual course of its affairs." A corporation is insolvent under the "legal" test if its liabilities exceed its assets.
Restraints On Alienation

A further limitation on the validity of a stock repurchase agreement is that the agreement must not be an unreasonable restraint on alienation. The Uniform Stock Transfer Act provides that no restriction on alienation will be valid against a transferee unless noted on the stock certificate.62 The full text of a restriction need not be written on the certificate. All that is required is reference to the restriction and the place where a full copy of it may be found. Normally, a restraint on alienation is invalid if it totally prohibits transfer.63 This problem generally does not arise in corporate repurchase plans since these plans allow transfer subject to the conditions of the agreement.

Remedies

Specific performance is usually granted where the corporation seeks to enforce the sale of stock.64 The reason is that stock in a close corporation is not readily obtainable in the market, and, therefore, because damages cannot be assessed, there is no adequate remedy at law.65 However, the shareholder may have difficulty in obtaining specific performance in that his right is to receive only money. Nevertheless, he may be allowed to recover where he can show that there is no way to determine damages at law because there is no market available for his stock.66

CONCLUSION

As a practical matter67 it is important to evaluate each individual situation to determine what plan, if any, is the best. The lawyer must not allow tax considerations to overrule good judgment in corporate management. Perhaps the use of a stock repurchase plan will defeat the intentions of the shareholders of a small corporation. The attorney should apprise his clients of the advantages and disadvantages of such a plan and be prepared to draft an agreement which will fulfill their needs.

BERNARD GOODMAN

62. OHIO REV. CODE § 1705.18. The same restriction is imposed in OHIO REV. CODE § 1701.25(B).
67. Consideration should be given to the use of a trustee to hold the insurance policies and the stock, endorsed in blank. When one of the parties dies, the trustee automatically turns the stock over to the corporation and turns the proceeds of the insurance policy over to the decedent's estate. This may prevent a party from refusing or hindering performance of the agreement.