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Corporations—Installment Stock Repurchase—Secured Claim Survives Bankruptcy—In re National Tile & Terrazzo Co., 537 F.2d 329 (9th Cir. 1976)

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CORPORATIONS—INSTALLMENT STOCK REPURCHASE—SECURED CLAIM SURVIVES BANKRUPTCY—*In re National Tile & Terrazzo Co.*, 537 F.2d 329 (9th Cir. 1976).

In re National Tile & Terrazzo Co.[1] allows, for the first time in the Ninth Circuit, a former stockholder's secured claim arising out of the corporate repurchase of stock to be provable in bankruptcy. This holding departs from the traditional rejection of such claims in favor of other creditors, and is unaffected by California's newly enacted corporations code.[2]

I. FACTS

Josephine Paterna owned 600 shares of the common stock of National Tile and Terrazzo Co., a California corporation. In December of 1967 she sold her shares back to the corporation for $39,000, accepting $3,000 in cash and a promissory note for the additional $36,000. The promissory note was secured by a deed of trust on certain real property owned by the corporation. At the time of the agreement, National deducted the entire purchase price from its earned surplus account in compliance with the California Corporations Code.[3]

The corporation made regular payments to Paterna on the promissory note until May 20, 1971. A month later, National filed a voluntary petition in bankruptcy. The corporation had no earned income and insufficient assets to pay all creditors in full. Paterna was still owed $20,351.66, and she filed her claim of lien in bankruptcy.[4] The

1. 537 F.2d 329 (9th Cir. 1976).

2. Law of Sept. 12, 1975, ch. 682, § 7, [1975] Cal. Stat. —, *as amended*, Law of Aug. 27, 1976, ch. 641, [1976] Cal. Stat. — [hereinafter cited as Gen'l Corp. Law].

3. Section 1707 provides in part:

> A corporation may also purchase shares issued by it, or by a corporation of which it is subsidiary, in any of the following cases:
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> . . . .
>
> (c) out of earned surplus. . . .

CAL. CORP. CODE ANN. § 1707 (West 1955).

Section 1709 provides in part:

> Upon any authorized purchase of shares issued by the corporation . . . out of earned . . . surplus the earned . . . surplus shall be reduced by an amount equal to the purchase price of such shares.

CAL. CORP. CODE ANN. § 1709 (West 1955).

4. The trustee in bankruptcy had liquidated the real property on which Paterna had her lien and placed the proceeds in a holding account pending the adjudication of Paterna's claim. Brief for Appellant at 4, *In re* National Tile & Terrazzo Co., 537 F.2d 329 (9th Cir. 1976).

district court affirmed the bankruptcy judge's denial of the lien on the basis of *In re Belmetals Manufacturing Co.*[5] The district court construed the *Belmetals* decision to mean that a promissory note, whether or not secured, given by a corporation in exchange for its stock is unenforceable when the corporation becomes insolvent.[6]

The Ninth Circuit Court of Appeals reversed the district court and upheld Paterna's claim. The court noted that *Belmetals* stood for the proposition that Paterna's promissory note was unenforceable under California law[7]—a conclusion expressly conceded by Paterna.[8] However, it was a question of first impression whether the lien created by the deed of trust survived when the note it was to secure became unenforceable. The court found inadequate precedent in California law to decide this issue and concluded on its own analysis that a lien arising out of a valid stock repurchase is enforceable.

II. Factors in the Court's Analysis

In reaching this decision the court faced a number of considerations which will be examined. First, the note-holding former stockholder traditionally has an inferior status in bankruptcy. Second, for statutory and common law reasons most courts have found a note arising from a stock repurchase to be unenforceable when the debtor corporation becomes insolvent. Third, if the note were secured by real property, the security may be of no consequence because under the majority rule the lien's viability rests upon the note's enforceability. This casenote examines the *National* court's treatment of these issues and the reasoning employed by the court to reach a result contrary to the traditional rejection of a former stockholder's claim in bankruptcy.

A. The Inferior Status of a Former Stockholder in Bankruptcy

Installment repurchasing of stock,[9] as practiced by National Tile

5. 299 F. Supp. 1290 (N.D. Cal. 1969), *aff'd sub nom.* Eranosian v. England, 437 F.2d 1355 (9th Cir. 1971).

6. 537 F.2d at 330. *See In re* Belmetals Mfg. Co., 299 F. Supp. 1290, 1296 (N.D. Cal. 1969), *aff'd sub nom.* Eranosian v. England, 437 F.2d 1355 (9th Cir. 1971).

7. See notes 42-44 *infra* and accompanying text for an analysis of the holding in *Belmetals* which indicates that the *National* court may have misconstrued *Belmetals.*

8. 537 F.2d at 330.

9. The repurchase of stock by publicly held corporations has been an increasingly common phenomenon in recent years. Between 1954 and 1963 more than fifty percent of the 1,214 corporations then on the New York Stock Exchange repurchased their own stock, often reflecting their mounting cash surplus. Buchalter, *Purchase by a Corpora-*

and Terrazzo, is often necessary for a small corporation with limited liquidity in order to avoid a cash flow problem.[10] It has been hindered, however, by the refusal of the courts to treat the note-holding former stockholder on a par with any creditor. Should the corporation become bankrupt while money is still owing on the stockholder's promissory note, the former stockholder has generally been unable to recover, and almost never on a par with other creditors, due to statutory and common law limitations.[11] These limitations have been extended to prohibit installment payments to the former stockholder during the corporation's insolvency and to bar the former stockholder's recovery in bankruptcy. This outcome corresponds to the bankruptcy rule that creditors recover completely before shareholders receive any return on their investment.[12]

The bias against a former shareholder has two bases. The first is the risk inherent in the nature of the original investment. Where the stockholder is gambling on the corporation's success, the creditor is merely rendering goods or services as part of a bargain supported by consideration. The second is the courts' historic view that the corporate repurchase of stock is fraught with opportunity for fraud.[13] It gives insiders a way to cash in on their investment just before insolvency, leaving nothing for creditors. Thus, courts have been wary of this type of transaction. These two factors have made it almost impos-

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tion of its Shares: Corporate Cannibalism Without Indigestion, 41 L.A.B. BULL. 446 (1966); Guthart, *More Companies Are Buying Back Their Stock*, 43 HARV. BUS. REV. 40, 42 (March-April 1965). Some reasons for repurchase in addition to the investment of a cash surplus are the compromise of a claim, compensation of a dissenting shareholder, funding of an agreement with employees such as a stock option plan, and the elimination of fractional shares. *See generally* 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 147 (4th ed. 1966) [hereinafter cited as BALLANTINE & STERLING].

10. Small corporations are rarely motivated by an excessive cash surplus as is a large, public corporation. A typical reason for the repurchase of stock in a small corporation is the death of one of the stockholders who was also active in the management of the business. *See* Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960).

11. *See* Jarroll Coal Co. v. Lewis, 210 F.2d 578 (4th Cir. 1954); Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935); *In re* Fechheimer Fishel Co., 212 F. 357 (2d Cir.), *cert. denied*, 234 U.S. 760 (1914); *In re* Bell Tone Records, Inc., 86 F. Supp. 806 (D.N.J. 1949); Quinn-Marshall Co. v. McDaniels Co., 5 F. Supp. 937 (M.D.N.C. 1934). *But see* Wolff v. Heidritter Lumber Co., 163 A.2d 140 (N.J. 1932), where the court, upholding the minority view, sustained a stockholder's claim in bankruptcy. *See generally* Annot., 47 A.L.R.2d 758 (1956).

12. Hoover Steel Ball Co. v. Schafer Ball Bearings Co., 106 A. 471 (N.J. Eq. 1919).

13. BALLANTINE & STERLING, *supra* note 9, § 146. *See* note 21 *infra* for the English rationale on the opportunity for fraud in stock repurchases.

sible for a former shareholder holding a promissory note at the time of bankruptcy to recover when competing with other creditors. Ingenious schemes have been unable to escape this result in jurisdictions adhering to the traditional view.[14]

In two recent cases, however, *Tracy v. Perkins-Tracy Printing Co.*[15] and *Williams v. Nevelow*,[16] which concerned installment repurchasing, the former stockholder was allowed to recover on a par with other creditors where the stockholder's note was secured by a chattel mortgage. Both cases took advantage of the bankruptcy rule which gives the secured creditor a favored position over the unsecured creditor,[17] but they circumvented the rule of secured transactions in real property which bases the viability of the lien on the enforceability of the underlying note.[18]

In *Tracy* the court based its holding on the validity of the lien, finding that the rights of the former stockholder to the proceeds of the property covered by the mortgages vested when they were executed.[19] *Williams*, interpreting the Texas Corporation Act, found the promissory note, and thus the lien, enforceable.[20] The Ninth Circuit in *National* followed the former path and found the lien, but not the note, enforceable. An examination of California law will indicate why.

B. The Enforceability of the Note Under the California Corporations Code

In the United States,[21] courts have allowed corporations to repurchase their own stock if the repurchase would not cause prejudice to

14. For an interesting attempt, *see* United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961).

15. 153 N.W.2d 241 (Minn. 1967).

16. 513 S.W.2d 535 (Tex. 1974).

17. Encumbered assets are applied in bankruptcy first to the claims of secured creditors before they are available for general creditors. 3 COLLIER ON BANKRUPTCY § 60.01 (14th ed. 1975). A secured creditor may file a claim as a general creditor for any amounts owing to him not already satisfied by the lien proceeds. *Id.* § 57.07. The secured interest is favored because the recordation of the lien gives notice to subsequent creditors that certain assets of the corporation have a prior claim on them should bankruptcy occur. The law expects subsequent creditors to act on such knowledge in extending credit.

18. G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 267 (1951).

19. 153 N.W.2d 241, 246 (Minn. 1967).

20. 513 S.W.2d at 537-38.

21. In England stock repurchases are not allowed. The English courts reason that private funds, not corporate capital, should be put to such a purpose. For a leading case on the subject and an explanation for distrusting stock repurchasing, *see* Trevor v. Whitworth, [1887] 12 App. Cas. 409, 416-17.

the rights of creditors.[22] This common law "no prejudice" rule took the statutory form of the insolvency cut-off rule, which specified that no stock repurchase could be made if the corporation were insolvent or if such a purchase would lead to its insolvency.[23] When the insolvency cut-off rule was extended to installment repurchases, most courts interpreted this provision to mean that solvency was required both at the time of purchase and at the time of each subsequent payment.[24] Under this interpretation, if a stockholder receives a promissory note as the result of a stock repurchase made when the corporation is solvent, then that note is voidable if the corporation later declares bankruptcy.[25]

Complicating the insolvency cut-off rule has been the more recent statutory requirement in California and other states[26] that a stock repurchase, except for specified statutory reasons,[27] must be made out of earned surplus.[28] Under this requirement, the entire amount of the cash purchase price must be available in earned surplus and must be deducted from earned surplus on the corporate books at the time of repurchase.[29] While the aim of this requirement is to protect creditors

22. *See* Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303 (1965) [hereinafter cited as Herwitz]. California generally did not permit stock repurchase until 1929 when the first comprehensive corporations law became effective, which permitted repurchase of stock under close restrictions. Ballantine, *Questions of Policy in Drafting a Modern Corporation Law*, 19 CALIF. L. REV. 465, 479 (1931). *See, e.g.*, England v. Christensen, 243 Cal. App. 2d 413, 422-23, 52 Cal. Rptr. 402, 408-09 (1966) on California's cautious policy towards stock repurchase.

23. *See, e.g.*, CAL. CORP. CODE ANN. § 1708 (West 1955).

24. *See, e.g.*, Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935).

25. *Id.* at 758.

26. Alabama, Alaska, Colorado, Connecticut, Georgia, Indiana, Iowa, Mississippi, Nebraska, New Mexico, North Dakota, Oregon, South Carolina, South Dakota, Tennessee, Virginia, Utah, Washington, and Wyoming have comparable provisions. *See* MODEL BUS. CORP. ACT ANN. § 6, ¶ 3 (2d ed. 1971).

27. A repurchase out of stated capital may be made to collect or compromise debts, to eliminate fractional shares, to relieve a dissenting shareholder, or pursuant to a stock option plan. CAL. CORP. CODE ANN. § 1706 (West 1955).

28. *Id.* § 1707(c). Many states enforcing the "earned surplus" requirement have defined earned surplus in terms equivalent to those found in the Model Business Corporation Act, which provides:

> "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus.

MODEL BUS. CORP. ACT ANN. § 2, ¶ 1(1) (2d ed. 1971). California has adopted no statutory definition of earned surplus, although it does have an earned surplus requirement. BALLANTINE & STERLING, *supra* note 9, § 127.

29. *E.g.*, CAL. CORP. CODE ANN. § 1709 (West 1955). *See* note 3 *supra*.

by insuring that stock repurchases do not deplete the company's capital while leaving nothing for creditors in bankruptcy, this provision has made installment repurchase of stock more troublesome.

Courts have been uncertain when to apply the earned surplus requirement. Should it be applied only at the time of purchase (in the case of installment repurchase at the time of the agreement and initial exchange of consideration) or, like the insolvency requirement, also at the time of payment?[30] The Model Business Corporation Act treats these questions by indicating that the earned surplus requirement should be applied only at the time of purchase, whereas the insolvency cut-off rule should be applied both at the time of purchase and at the time of payment.[31]

The present California statute fails to treat separately the question of payment and gives no indication when the earned surplus requirement of section 1707(c)[32] or the insolvency cut-off rule of section 1708[33] is to be applied. These sections simply indicate that a corporation may "purchase" shares out of earned surplus and shall not "purchase" shares if such purchase might reasonably lead to insolvency.

30. In Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), the court avoided the potential severity of applying the earned surplus requirement both at the time of purchase and at the time of payment by applying it only at the time of payment. The court regarded the initial purchase agreement as conditional in order to avoid potential danger to creditors. *See* Herwitz, *supra* note 22, at 311-23 for a criticism of this interpretation of the earned surplus requirement. *See generally* Annot., 61 A.L.R.3d 1049 (1975).

31. The Model Act was amended in 1957 to read:

> 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.

MODEL BUS. CORP. ACT ANN., § 6, ¶ 1 (2d ed. 1971) (emphasis added). The Texas Business Corporation Act, which was interpreted in Williams v. Nevelow, 513 S.W.2d 535 (Tex. 1974), was amended in accordance with the Model Act to include the word "payment" in the insolvency provision. The accompanying comment expressly indicates that the intent of the amendment was to apply the insolvency limitation both at the time of purchase and at the time of payment, while restricting the earned surplus requirement to the time of purchase. TEXAS BUS. CORP. ACT art. 2.03(D)(F) (Supp. 1975-76).

32. Section 1707 provides in pertinent part:

> A corporation may also purchase shares issued by it . . . in any of the following cases:
>
> . . . .
>
> (c) Subject to any limitations contained in its articles, out of earned surplus. . . .

CAL. CORP. CODE ANN. § 1707 (West 1955).

33. Section 1708 provides in pertinent part:

> A corporation shall not purchase or redeem shares issued by it . . . in any case when there is reasonable ground for believing that the corporation is unable, or, by such purchase or redemption, will be rendered unable, to satisfy its debts and liabilities when they fall due . . . .

CAL. CORP. CODE ANN. § 1708 (West 1955).

In applying these standards to the facts of *National*, the problem of interpretation becomes apparent. First, if the word "purchase" is understood to include subsequent payments in addition to the initial transaction, Paterna's note is probably unenforceable since at the time of payment the corporation had no earned surplus and was insolvent.[34] Second, if "purchase" not only means the initial transaction for purposes of the earned surplus requirement, but means both the initial transaction and subsequent payments for purposes of the insolvency cut-off, the note is probably unenforceable because at the time of subsequent payments the corporation was insolvent. This is the interpretation of the Model Act.[35] Third, if "purchase" means only the initial transaction for purposes of both sections, the note is probably enforceable because the corporation had adequate earned surplus to cover the purchase price and, of course, was solvent.[36]

The first and second alternatives extend the common law "no prejudice" rule to encompass installment repurchasing.[37] However, a strict statutory examination yields a result closer to the third interpretation.[38] The California Commercial Code defines "purchase" as

34. But if payment is defined to include the transfer of a negotiable promissory note, as is suggested by the definition of "value" under the Texas Business and Commerce Code, the note would be enforceable. *See* TEX. CODE BUS. & COM. § 1.201(44) (1968); Hartmann & Wilson, *Payment for Repurchased Shares Under the Texas Business Corporation Act*, 26 SW. L.J. 725, 735 (1972).

35. *See* note 31 *supra*.

36. The concurring opinion in *National* points out that a transaction like Paterna's is a fully executed contract under California law. 537 F.2d at 333 (Real, J., concurring). According to this reasoning, the third alternative is thus the appropriate statutory interpretation in an installment repurchase transaction where all the stock was exchanged for a promissory note. As the majority opinion points out, this reasoning begs the question. The issue of whether payments may be made on a stock repurchase when there is no earned surplus and the corporation is insolvent remains whether or not the contract is termed "executed." *Id.* at 330 n.2.

37. Since the aim of the rule was to preserve assets for creditors at the time of insolvency, it did not matter when the initial transaction was made or whether it was valid at the time. The classic articulation of this position stated:

> When such a transaction is had, regardless of the good faith of the parties, it is essential to its validity that there be sufficient surplus to retire the stock, without prejudice to creditors, *at the time payment is made* out of assets.

Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935) (emphasis added).

In McConnell v. Butler, 402 F.2d 362, 366-67 (9th Cir. 1968), the Ninth Circuit analogized to *Robinson*, where a note had been given, and held that exchanging stock for debentures was not "payment."

38. Using statutory interpretation, the court in Williams v. Nevelow, 513 S.W.2d 535 (Tex. 1974), found numerous reasons for upholding the claim. First, Texas law clearly specifies that earned surplus must be present "at the time of purchase," indicating that the earned surplus requirement does not apply to subsequent payments. *Id.* at 537. Second, a different holding would in effect "require as much as double the amount" of

"taking by . . . mortgage . . . [or] lien. . . ."[39] Thus, the installment repurchase transaction in *National* constituted a "purchase" under California law. Following this line of reasoning, the purchase referred to in section 1707(c) and section 1708 takes place at the time the secured note is given to a stockholder in exchange for his stock and, thereafter, the corporation is simply making payments on a negotiable secured instrument, an activity not prohibited by the statute.[40]

The distinctions required for this statutory analysis have been lost by courts applying California law. Indeed, recent Ninth Circuit decisions in this area have displayed considerable confusion in their analysis.[41] The most recent case applying California law to the installment repurchase issue was *Belmetals*,[42] which was understood by the *National* court to bar any payment when it could not be made from earned surplus, although the facts in *Belmetals* make that conclusion questionable. The *Belmetals* court found the repurchase transaction invalid from the outset because the corporation never had adequate earned surplus to repurchase the shares in question.[43] The court's additional conclusion—that even if the transaction were not void from

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earned surplus. Not only would the purchase price be deducted from the present earned surplus account, but in addition each individual payment would also have to be made out of earned surplus. *Id.* at 538. Third, even if the earned surplus requirement were extended to subsequent payments, the unenforceability of the stockholder's claim would not necessarily follow because "[t]he issuance of a secured negotiable instrument could be considered 'payment' for the repurchased stock," and nowhere does the statute specify that secured instruments must be paid from earned surplus. *Id.* at 539. Fourth, "[i]f fraud or bad faith or conduct misleading to the creditors were shown, equitable ground for rescission of the purchase and the foreclosure would be established" and the statute would not need to be distorted to support unenforceability if fraud were the real ground. *Id.* at 538.

39. CAL. COMM. CODE ANN. § 1201(32) (West 1964). This section, which became law January 1, 1965, repealed section 2455 of the California Corporations Code which defined "purchase" to include acquisitions "as mortgagee or as pledgee." *Id., repealing* Uniform Stock Transfer Act, ch. 1038, § 2455, [1947] Cal. Stat. 2354 (repealed 1965).

40. *Accord,* Williams v. Nevelow, 513 S.W.2d 535, 537-39 (Tex. 1974).

41. *See* McConnell v. Butler, 402 F.2d 362 (9th Cir. 1968), wherein the court relied on Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935), and ignored the California Corporations Code in denying the unsecured claims of debenture-holding former stockholders in bankruptcy. The "time for payment," the *McConnell* court held, is when assets are actually passed; the exchange of debentures for stock is not payment. 402 F.2d at 366-67.

42. 299 F. Supp. 1290 (N.D. Cal. 1969), *aff'd sub nom.* Eranosian v. England, 437 F.2d 1355 (9th Cir. 1970).

43. 299 F. Supp. at 1293. The court found that the stockholders knew of this deficiency and attempted to fabricate the necessary surplus by fraudulent accounting. This failure to comply with section 1707(c) at the time of purchase in and of itself made the note in *Belmetals* unenforceable in bankruptcy. *Id.*

the beginning, precedent in California would have rendered the remaining payments unenforceable upon insolvency—was gratuitous.[44]

Other decisions referred to in *Belmetals* are equally unenlightening on the subject of the viability of a note, given to a former stockholder for the repurchase of shares, in bankruptcy. For example, *In re Mathews Construction Co.*,[45] cited in *Belmetals*,[46] squarely considered the stock repurchase issue in bankruptcy since there was a valid obligation at the inception. *Mathews* held that under California law the earned surplus requirement was applicable to an installment stock repurchase payment.[47] The court relied completely on *Goodman v. Global Industries*[48] but failed to consider *Goodman's* different factual setting.[49]

The stock in *Goodman* was initially purchased with the understanding on the part of the shareholder that the corporation would buy it back at his request. When the stockholder later exercised his option, the corporation refused to repurchase the stock on the grounds that it had no earned surplus and thus was not legally able to perform. The stockholder sued the corporation on its promise to repurchase and the court found for the corporation.[50] The *Goodman* agreement was thus executory on both sides. The stockholder had never parted with any stock; the corporation had never parted with any money. The validity of an installment repurchase in which the contract had been executed by the stockholder but was still executory on the part of the corporation was not at issue. Nevertheless, *Mathews*[51] and *Belmetals*[52] cite *Goodman* as definitive on the installment repurchase issue.

The *National* court, unwilling to battle precedent without specific guidance from the legislature, found Paterna's promissory note unenforceable on the basis of the insolvency cut-off rule and the earned surplus requirement.[53] Thus, the court turned to the lien as a way to salvage Paterna's claim.

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44. *Id.* at 1296.
45. 120 F. Supp. 818 (S.D. Cal. 1954).
46. 299 F. Supp. at 1296.
47. 120 F. Supp. at 821.
48. 80 Cal. App. 2d 583, 182 P.2d 300 (1947).
49. 120 F. Supp. at 821.
50. 80 Cal. App. 2d at 588, 182 P.2d at 303.
51. 120 F. Supp. at 821.
52. 299 F. Supp. at 1296.
53. 537 F.2d at 330. See text accompanying notes 32-40 *supra* for a discussion of the statutory basis on which the note could have been found enforceable, despite recent precedent to the contrary.

C. *The Enforceability of the Lien under California Law*

The vitality of a lien in California is determined by section 2909 of the California Civil Code, which provides:

> A lien is to be deemed accessory to the act for the performance of which it is a security, whether any person is bound for such performance or not, and is extinguishable in like manner with any other accessory obligation.[54]

Thus, where the obligation is cancelled, forgiven, or no longer exists, the lien is extinguished. Similarly, if the original holder of a secured promissory note transfers the note to one person and the security to another, the holder of the note still has the benefit of the security and the holder of the security has no benefit other than a possible action against the seller to compel him to transfer the note also, if that was part of the agreement.[55] Concisely stated, the lien follows the note.

California cases interpreting the validity of a lien when the note it secures becomes unenforceable fall into two classes: those where the note was originally invalid,[56] nonexistent[57] or extinguished by the

54. CAL. CIV. CODE § 2909 (West 1974). It should be noted that the result of the transaction would not have been significantly different under the provisions of the California Commercial Code governing secured transactions in personal property. CAL. COMM. CODE ANN. § 9101 *et seq.* (West 1964). Section 9201 of the commercial code COMM. CODE ANN. § 9101 *et seq.* (West 1964). Section 9201 of the Commercial Code provides that a valid security interest in personal property attaches when: (1) the debtor has signed a security agreement containing a description of the collateral; (2) value has been given; and (3) the debtor has rights in the collateral. The important point here is the focus on "value" being given. Under section 1201(44) value is defined in part as "any consideration sufficient to support a simple contract." CAL. COMM. CODE ANN. § 1201(44)(d) (West Supp. 1976). Therefore, once these initial steps have been taken a valid security interest is taken in the debtor's property. The commercial code does not confront the situation where the underlying "value" later becomes "unenforceable" or "insufficient to support a simple contract."

There would appear to be two possible consequences of this conflict under the provisions of the commercial code. First, section 9201 contains the general provision upholding the validity of a security interest, "[e]xcept as otherwise provided by this code a security agreement is effective according to its terms . . . ." Therefore, the security interest "lien" if validly given, would appear to be unaffected by the underlying consideration later becoming insufficient. However, it is possible that the term "except as otherwise provided" could be interpreted to mean that one should look for the solution to this problem outside the code, as provided by section 1103. CAL. COMM. CODE ANN. § 1103 (West 1964). This would mean using California common law on the subject, *i.e.*, the same problem the *National* court faced.

55. Kelley v. Upshaw, 39 Cal. 2d 179, 246 P.2d 23 (1952); Treat v. Burns, 216 Cal. 216, 13 P.2d 724 (1932). *See generally* Bernhardt, *The Obligation*, CAL. REAL ESTATE SECURED TRANSACTIONS § 4.1 *et seq.* (J. Hetland ed. 1970).

56. Fleming v. Kagan, 189 Cal. App. 2d 791, 11 Cal. Rptr. 737 (1961).

57. Coon v. Shry, 209 Cal. 612, 289 P. 815 (1930).

maker;[58] and those where the note is simply unenforceable due to the statute of limitations.[59] A typical case of the first type is where a decedent's will forgave money owed on a promissory note but neglected specifically to extinguish the deed of trust held by a trustee as security for the note. Because the lien follows the obligation, the forgiveness of the debt extinguished the lien.[60]

Cases of the second type, where the note is not invalid but simply unenforceable due to the statute of limitations, produce a slightly different result. Although the courts have agreed that section 2909 of the Civil Code bars a foreclosure action because the enforceability of the lien is dependent on the enforceability of the note, they have held that title may not be quieted against the holder of a trust deed without payment of the note,[61] and that where the mortgagee was in possession no ejectment action could be maintained against him.[62]

As the court in *National* reasoned, while Paterna's note was unenforceable, it was not unenforceable because the note was extinguished by the maker or invalid from its inception. Nor was it invalid due to a mere procedural obstacle such as the statute of limitations. The note was unenforceable, as the court interpreted it, because of a substantive rule of California law, a more serious ground for unenforceability than the statute of limitations, but less serious than original invalidity.[63] Finding no precedent directly on point, the court examined the reasons behind the unenforceability of the note and ruled that they were not sufficient to merit extinction of the lien along with the extinction of the note.[64]

One may question the consequences of a rule which permits a lien to survive an unenforceable note. Fortunately, the survival is based on narrow grounds. A note void from the beginning is not protected

58. Trowbridge v. Love, 58 Cal. App. 2d 746, 137 P.2d 890 (1943).
59. Howell v. Dowling, 52 Cal. App. 2d 487, 126 P.2d 630 (1942).
60. Trowbridge v. Love, 58 Cal. App. 2d 746, 137 P.2d 890 (1943).
61. Howell v. Dowling, 52 Cal. App. 2d 487, 496, 126 P.2d 630, 635 (1942).
62. Puckhaber v. Henry, 152 Cal. 419, 423, 93 P. 114, 116 (1907).
63. 537 F.2d at 331.
64. The court's analysis parallels *Tracy v. Perkins-Tracy Printing Co.* which the court cites approvingly:

> With no Minnesota decisions in point involving these aspects of the case, we prefer to leave resolution [of the validity of the note] for legislative clarification and rest our decision, as we believe the trial court did, upon the ground that the rights of the plaintiff to the proceeds of the personal property embraced in the chattel mortgages vested when the mortgages were executed and cannot be voided now by resort to [the Minnesota earned surplus requirement].

153 N.W.2d at 246.

by the *National* holding.[65] The decision protects only a lien securing a note valid at its inception which later becomes unenforceable in bankruptcy. The lien provided a narrow ground on which the court could uphold a stock repurchase obligation and thus avoid directly overruling the *Belmetals* insolvency cut-off rule without the specific authorization of the legislature.

III. THE DECISION: A NEW OUTCOME FOR THE STOCKHOLDER

The precedent-setting outcome of the *National* decision is highlighted by the underlying rationale of the court in finding the lien to be enforceable. The court's reasoning, as opposed to its actual holding, is directed towards finding the note to be enforceable.[66]

The court maintained that California law indicated the note was unenforceable, but earlier analysis demonstrates that the cited cases do not necessitate such a conclusion.[67] One wonders whether, if counsel for Paterna had argued on behalf of the note's validity instead of conceding its invalidity, the court might have looked more favorably upon the note's enforceability, distinguishing the weak precedent to the contrary. In addition, the court ignored an exercise of statutory interpretation which could have provided the basis for finding the note enforceable.[68] On the other hand, the court cited and found persuasive equally weak precedent to support the enforceability of the lien.[69]

The *National* decision makes sense, not on the basis of precedent, but on the basis of policy. In upholding Paterna's claim, the court offered a variety of reasons, none of which readily appears from prior case law. The court noted first that the corporation could have paid cash at the time of the transaction, since it had the necessary earned surplus required by section 1707(c).[70] Second, the court found the transaction to be free of fraudulent dealing.[71] Third, the court stated

65. See text accompanying notes 56-57 *supra*. Whether the *National* holding affects a lien where the note was extinguished is unclear but seems unlikely. See text accompanying note 58 *supra*.

66. See text accompanying notes 70-76 *infra*.

67. See text accompanying notes 41-52 *supra*.

68. See notes 38-40 *supra* and accompanying text.

69. 537 F.2d at 331.

70. *Id.* *See* CAL. CORP. CODE § 1709 (West 1955), which requires the corporation to deduct the entire purchase price from the earned surplus account, a requirement met by National Tile & Terrazo Co. Thus, on the basis of the balance sheet, the transaction is fully executed at that time.

71. 537 F.2d at 331.

that the enforcement of installment repurchase agreements was necessary to enable the corporation to buy its stock in the most expeditious and convenient manner.[72] Even though earned surplus in excess of the entire purchase price may be available, the corporation may be well-advised to conserve some of its funds at the time of purchase. Fourth, since Paterna had already sold her shares and therefore no longer possessed the benefits of risk capital in terms of corporate control, dividends, or the speculative rewards of investment, the court found it appropriate to relieve Paterna of the risk of shareholder status in the bankruptcy proceeding.[73] Each of these explanations could apply with equal force to support a claim based upon an unsecured obligation, a result diametrically opposed to the traditional view.

Only the court's fifth reason applies solely to a secured transaction. The court noted that a lien, when it is recorded, supplies notice to creditors, something a mere promissory note may not do.[74] The court reinforced this conclusion by noting that a slight change in form would have rendered the transaction completely unassailable—namely, payment in full to the shareholder, financed in part by a third party's secured loan to the corporation.[75] This argument, while valid, may go beyond what the court intends because it would also support the unsecured claim of a former stockholder who could assert a similar change in form.[76]

While *National* may seem to be going in the back door by finding the claim valid only because the lien is enforceable, the substantive significance of the lien should not be overlooked. The insistence on the presence of a lien is in fact an extension of the original common law rule that no stock repurchase, including a stock payment due under an installment plan, may be made if it will prejudice a creditor's legal rights. By noting the significance of the lien, the *National* court recognized the traditional pecking order in insolvency—namely, that unsecured creditors have a claim only on those resources of the bankrupt that do not have recorded liens against them. The object of the lien

72. *Id.* at 332.

73. *Id.* This qualification may result in the rejection of the claim of a stockholder who sells less than all of his stock. However, such a result would not necessarily be dictated by the offered interpretation of the new corporations code. See text accompanying notes 78-82 *infra.*

74. 537 F.2d at 332.

75. *Id.*

76. Tracy v. Perkins-Tracy Printing Co., 153 N.W.2d 241 (Minn. 1967), offers another example. A stockholder could take cash for his stock and then loan money back to the corporation secured by a chattel mortgage. *Id.* at 247.

is thus to give bona fide creditors notice of the continuing obligation of an installment stock repurchase and allow them to adjust their extension of credit accordingly.[77]

IV. Effect of the New California General Corporations Law on Stockholders' Secured Claims in Bankruptcy

The revised California Corporations Code, effective January 1, 1977,[78] would appear to have little effect on the outcome in *National*. In place of the earned surplus requirement, section 500 of the new code provides that, immediately prior to the repurchase, the corporation must have retained earnings equal to or in excess of the purchase price; or that, immediately after giving effect to the repurchase, the sum of the assets of the corporation must at least equal its liabilities according to specified formulas.[79] Section 501 is a slightly reworded version of the insolvency cut-off rule.[80] Thus neither section 500 nor section 501 sheds light on the key issue in installment repurchasing: when are these standards to be applied?

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77. First Trust Co. v. Illinois Cent. R.R., 256 F. 830 (8th Cir. 1919); Cross v. Beguelin, 169 N.E. 378 (1929). This reasoning would apply only to creditors subsequent to Paterna's recordation of the lien. The *National* court did not specify whether there were creditors whose liens originated prior to this date. Bankruptcy occurred three and one-half years after the lien recordation, and following the deduction of the repurchase price the corporation had remaining more than $20,000 in earned surplus. These facts made it likely that the creditors contesting Paterna's claim were subsequent to her stock repurchase transaction.

78. Gen'l Corp. Law, *supra* note 2, § 1 *et seq.*

79. Section 500 reads in pertinent part:

> Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) unless:
>
> (a) The amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution; or
>
> (b) Immediately after giving effect thereto:
>
> (1) The sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 1¼ times its liabilities (not including deferred taxes, deferred income and other deferred credits); and
>
> (2) The current assets of the corporation would be at least equal to its current liabilities or, if the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for such fiscal years, at least equal to 1¼ times its current liabilities; . . .

Gen'l Corp. Law, *supra* note 2, § 500.

80. Section 501 provides:

> Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.

Gen'l Corp. Law, *supra* note 2, § 501.

More relevant to this question, however, is the revised code's definition of the time of distribution:

> [T]he time of any distribution by purchase or redemption of shares shall be the date cash or property is transferred by the corporation, whether or not pursuant to a contract of an earlier date; provided, that where a negotiable debt security (as defined in subdivision (1) of Section 8102 of the Commercial Code) is issued in exchange for shares the time of the distribution is the date when the corporation acquires the shares in such exchange.[81]

The requirements of sections 500 and 501 are both applicable at the time of distribution, which, under this provision, is whenever cash or property is transferred from the corporation.[82] Thus, both the surplus and solvency tests must be met for each payment as well as for the initial purchase, a reaffirmation of the traditional rule.

The possible exception to this rule—the situation where a negotiable debt security is given in exchange for the stock—would rarely apply to such a transaction and does not apply in *National* because the definition of negotiable debt security under the California Commercial Code is quite limited:

> (a) A "security" is an instrument which
>
> (i) Is issued in bearer or registered form; and
>
> (ii) Is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and
>
> (iii) Is either one of a class or series or by its terms is divisible into a class or series of instruments; and
>
> (iv) Evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.[83]

Thus, under the new Corporations Code, the holding in *National* would still rest on the viability of the lien and not the enforceability of the note.

V. CONCLUSION

The decision in *In re National Tile & Terrazzo Co.* will have a definite and continuing impact on corporations, their stockholders, and their creditors. Small corporations, most importantly, will have more freedom in repurchasing stock on an installment basis. Wise shareholders will not be reluctant to enter into such an agreement which formerly

81. *Id.* § 166.
82. *Id.*
83. CAL. COMM. CODE ANN. § 8102(1)(a) (West 1964).

would have placed them in an inferior status to creditors. Creditors, on the other hand, potentially could get a smaller piece of the pie in a bankruptcy proceeding.[84]

This departure from the majority rule is, however, not as radical as it might have been. By narrowly finding that the lien was enforceable, despite the unenforceable note, the Ninth Circuit avoided the direct overruling of California precedent while offering the former stockholder a way to recover on his claim.[85]

The new California Corporations Code is marred by the same pitfalls as the old for the installment repurchase transaction.[86] Thus, one may assume that the security interest found valid in *National* will become an important way to circumvent a bad result for the former stockholder. Courts applying the holding of *National* will find a former stockholder's claim provable in bankruptcy as a creditor if (1) the debt is secured; (2) there is no evidence of fraud; and (3) the new statutory requirements for surplus are met at the time the corporation repurchased the stock. This relaxation of the requirement that sufficient earned surplus and solvency be present both at the time of purchase and at the time of payment will facilitate stock repurchase transactions and bring the law more in line with prevailing business practice.

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84. Judge Goodwin, in dissent, worried that the *National* decision could "frustrate present and future creditors of other small, closely held corporations." 537 F.2d at 333 (Goodwin, J., dissenting).

85. See note 64 *supra* and accompanying text.

86. Gen'l Corp. Law, *supra* note 2, § 166. See notes 80-81 *supra* and accompanying text.