

**Meaning, Functions, and Problems Corollary to Stock
Repurchases in Delaware and New York: Lessons for the
Republic of Azerbaijan**

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LL.M. Capstone Thesis

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Abstract

The application of stock repurchases in the activities of corporations has gradually been increasing in the last decades. However, the understanding of the economic role of stock repurchases and the connected regulatory policies in various legal systems are quite different. As a result, different attitudes lead to the formation of different rules and standards, some of which sometimes seem to be erroneous and inappropriate. Particularly in Azerbaijan, the general perception of share buybacks is different from that in the US. After Azerbaijan gained independence in 1991, capitalism began to emerge in the country, and new concepts such as private property and private company began to appear in society. A sharp transition from socialism to capitalism was reflected in the reform of legislation, but reforms in developing countries are not always successful and sometimes even cause problems.

One such problem in Azerbaijan is in the rules regulating the field of corporate finance. In this connection, the dominating line of the present thesis is in revealing solutions to some problematic issues regarding the perception and practical application of share buybacks in Azerbaijan on the example of good experiences and practices of the United States.

For this reason, the present thesis focuses on the differences of the legal treatment of stock repurchases in the jurisdictions of the US – the legislation and regulatory policies of the States of Delaware and New York – and the Republic of Azerbaijan (hereinafter: Azerbaijan). Particularly, the legal framework of the States of Delaware and New York were chosen as they are two leading jurisdictions in this domain. The thesis addresses the differences in meaning and functions of stock repurchase, as well as the economic consequences of distinct attitudes towards the function of stock repurchase. In addition, the paper analyzes which attitudes are more advantageous and what are their reasons. Finally, based on a comparative analysis, the thesis will come forward with recommendations for Azerbaijan regarding appropriate changes in legislation.

List of abbreviations

BOD – Board of Directors

CCAR – The Constitutional Court of the Republic of Azerbaijan

CJSC – Closed Joint Stock Company

DGCL – Delaware General Corporation Law

EPS – Earning Per Share

GM – General Meeting of shareholders

JSC – Joint Stock Company

LLC – Limited Liability Company

MBCA – Model Business Corporation Act

MSV – Maximizing Shareholder Value

NYBCL – New York Business Corporation Law

NYSE – New York Stock Exchange

OJSC – Open Joint Stock Company

SEC – Securities Exchange Commission

Introduction

The operation of commercial legal entities assumes use of different business strategies and adoption of various decisions due to dynamic development that takes place in modern business environment. One set of such corporate actions concerns the repurchases of shares from the shareholders.

(a) Why focus on stock repurchases?

Stock repurchase is an important technique for the company that is implemented for different operational, economic and governance purposes. During recent decades, stock repurchases are gaining in popularity.¹ In Azerbaijan, stock repurchases (also: share repurchases) are perceived exclusively as a method for the reduction of the amount of the charter capital and number of outstanding shares of the joint stock companies, whereas in other countries (including the US) the main function of such transactions is to be an alternative for rewarding the shareholders by declaring and distributing dividends.² In other words, the legislation of Azerbaijan does not see the stock repurchase mechanism as a tool to reward the shareholders. Furthermore, in Azerbaijan, during the repurchase of the shares of the minority shareholders by a company, the sales price is to be equal to their liquidation value as pronounced in the Resolution of the Constitutional Court in December 16, 2011. Situations causing the purchase of shares of minority shareholders by the issuer are, for instance, when minor shareholders require from companies to repurchase their shares in connection with being against the decision of the major shareholders to merge or transform the organizational-legal form of the company from Open Joint Stock Company (OJSC) to Limited Liability Company (LLC). However, the change of

¹ Alberto Manconi, Urs Peyer, Theo Vermaelen, *Buybacks Around the World*, FINANCIAL AND QUANTITATIVE ANALYSIS, (April 30, 14:50 PM), <http://www.dimfunds.com/wp-content/uploads/2018/05/Buybacks-Around-the-World-Manconi-Peyer-and-Vermaelen-2015.pdf> .

² See the second chapter of the thesis.

the organizational-legal form does not mean that the OJSC ceases to exist but continues, and I opine that in such case it is quite erroneous to state that the sale price of the shares should be at liquidation value (as if OJSC liquidates). The thesis will determine reasons for the mentioned allegations and will give appropriate solutions.

(b) The jurisdictions within the purview of the thesis

Being a post-Soviet state, Azerbaijan had for 70 years lived according to the rules of communism where such concepts as private ownership or private legal entities were unfamiliar. After the collapse of the Soviet Union, Azerbaijan obtained independence and abruptly switched from socialism to capitalism. With the passage of time, a legislative base began to be created from scratch to regulate corporate law and corporate finance. Since that time, many laws have been enacted that are compatible with the standards contained in the legislations of developed capitalist countries, but I believe that still much remains to be done. In particular, the above mentioned problems exist regarding stock repurchases, and therefore, they constitute a cornerstone of the present thesis.

In order to determine appropriate recommendations and suggestions on the solutions of the above mentioned problematic issues regarding the share repurchases in the Republic of Azerbaijan, the legislation and policies of the US States of Delaware and New York were chosen to compare with and introduced as an illustration of one of the most advantageous and beneficial models for the regulation of share repurchases. The reason for that is the fact that the largest amount of the transactions with securities (particularly, share buybacks) takes place on the famous stock exchanges of the US such as the New York Stock Exchange (NYSE) or NASDAQ Stock Market (electronic stock market) and undeniably play a great role in the overall economy of the US which is generally confessed to be the strongest in the world. With regards to the choice of the Delaware jurisdiction for comparison, the main reason is the strong

authority of the Delaware judiciary. It is important to note that lawyers from other states also frequently resort to “Delaware case law as a guidance if there exists no binding precedent or controlling statute in the relevant states of incorporation.”³

(c) Methodology and the Scholarship on Stock repurchases

The methodology of the research is a comparative analysis within the doctrinal legal research of the legislative acts and regulations in the selected jurisdictions of the US and Azerbaijan. With regards to the materials on stock repurchase related to Azerbaijan, it is relevant to mention that the legislation of Azerbaijan in this regard is not so much extensive and detailed. Therefore, certain norms from Civil and Tax Codes of Azerbaijan and two resolutions of the Constitutional Court of Azerbaijan are almost the entire law on the issues in the focus of this thesis. Although the scope of the regulatory framework is limited, the ‘if not prohibited, allowed’ principle is generally applicable.⁴ Indeed, the problem with non-treatment of share buybacks as an alternative for the distribution of dividends is mainly about rules contained in the tax laws of Azerbaijan which will be further discussed in more detail. Unfortunately, the legal scholarship on these issues in Azerbaijan is also weak and that is why, just few available sources will be used.

As far as the two selected States of the US are concerned, the picture is completely opposite, so that very detailed legislation,⁵ quite a lot of court cases and scholarship authorities exist regarding stock repurchases. The thesis will mainly focus on cases from the States of Delaware and New York; especially those, the factual circumstances of which are most compatible and

³ Michael P. Dooley and Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 THE BUSINESS LAWYER 737, 738 (2001).

⁴ AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 12.2 (Republic of Azerbaijan).

⁵ With regards to legislation, thesis will mainly analyze Delaware General Corporation Law and New York Business Corporation Law. *See*. Del. Code Ann. tit. 8; N.Y. Bus. Corp. Law.

appropriate to the context of above mentioned specific problems of stock repurchases in Azerbaijan.

(d) The road map to the thesis

To best present the topic of stock repurchases and the corollary problems in a comparative setting, the thesis will proceed as follows.

The first chapter starts with a clarification of the key notions and concepts connected to share repurchases, methods of realization of share repurchase programs, as well as its advantages and disadvantages. In the second chapter, the focus shifts to the treatment of stock repurchases as an alternative for the distribution of dividends; particularly, whether the legislation of Azerbaijan presumes such treatment. The third chapter of the thesis is devoted to the stock repurchases implemented in connection with realization of dissenting shareholders' appraisal rights. Particular attention is given to how the value of the shares should be determined and what should be taken into consideration. Lastly, some conclusions are drawn for Azerbaijan.

The reason for such an order of the thesis's chapters is to start with general concepts, then to switch to the central general problem and to conclude with elaboration on more specific and narrow issues.

Chapter I. Concept and nature of stock repurchases

1.1. Definition and reasons for stock repurchases

Admittedly, one of the main objectives of the operation of commercial legal entities is the generation of profits which should be paid to the shareholders for their contributions into the equity capital of the company.⁶ The payout policy of companies can be considered as mainly implemented through either declaration of dividends or repurchase of the stockholders' shares (a.k.a. "share repurchase", "share buyback"). Different sources offer various definitions for 'stock repurchase'.⁷ The following formulation expresses the idea of most definitions: "Stock repurchase is a transaction between the issuer and the stockholder whereby the former purchases the latter's shares through open marketplace or tender offer."

Stock repurchase is mainly treated as an alternative for the allocation of dividends or any other type of distributions. "Although companies have long been permitted to buy back their stock, it was not until the early 1980s that U.S. corporations began adopting share repurchase programs in large numbers."⁸ In the 1980s, US companies started to execute a lot of share repurchase transactions as a new way to reward shareholders.⁹ The number and volume of stock repurchase transactions have constantly been increasing during recent years and nowadays such transactions are becoming more and more popular. The monetary amount of both stock repurchases by S&P 500 companies and generally announced share buybacks were constantly

⁶ Of course, profits generated by the company are also frequently used for growth and expansion of business. However, the present thesis is mainly concerned with another not less important objective to distribute profits to the shareholders.

⁷ Caroline Banton, *Share Repurchase*, INVESTOPEDIA, (March 23, 2020, 01:44 PM), <https://www.investopedia.com/terms/s/sharerepurchase.asp>; NASDAQ Glossary, *Share Repurchase*, NASDAQ (March 23, 2020, 00:44 PM), <https://www.nasdaq.com/glossary/s/share-repurchase>; Adam Hayes, *Buyback*, INVESTOPEDIA, (March 23, 2020, 01:18 PM), <https://www.investopedia.com/terms/b/buyback.asp>.

⁸ Gustavo Grullon and David L. Ikenberry, *What do we know about stock repurchases?*, JOURNAL OF APPLIED CORPORATE FINANCE 31, 31 (2000).

⁹ Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?* 12 J. BUS. & RES. 193, 195 (2014).

and gradually increasing since the 1980s.¹⁰ For example, in 1985, the value of buybacks by S&P 500 companies was lower than \$50 billion, while their value at the beginning of 20th century reached approximately \$600 billion.¹¹ From then on, the pattern again was going up and reached its peak at approximately \$1000 billion in 2019.¹²

There are several reasons why companies resort to share buybacks. Firstly, companies start to think about share repurchase programs when they possess a lot of cash.¹³ Such a state of a company is called “sitting on cash”. In this case, the management of the company should decide whether to use ‘excess’ cash and expand business or distribute it to the shareholders. Another alternative such as to save money in the company is dangerous, because cash rich companies are tidbits in the eyes of the corporate raiders and can become a target for corporate takeover schemes.¹⁴

Secondly, many companies declare in their final annual reports that conduction of regular stock repurchase programs is necessary to satisfy their bonus and stock option plans.¹⁵ As it is known, in today’s corporate governance environment stock options are granted or sold not only to the existing or potential shareholders but also granted to the directors, officers and even employees as bonuses. Such transactions are usually considered to be positive employee-encouraging measures which “instigate” employees to treat interests of the company as their own personal interests.

Thirdly, some financial experts allege that there is an ideal proportion between debt and equity financing of the entity and that is why, a lot of companies implement stock repurchase

¹⁰ Jeff Desjardins, *The Controversy Around Stock Buybacks Explained*, VISUAL CAPITALIST, (April 28, 2020, 11:30 PM), <https://www.visualcapitalist.com/stock-buybacks-explained/>.

¹¹ *Ibid.*

¹² *Ibid.*

¹³ Sanford, J., *Taking a little back*, 78 CANADIAN BUSINESS 90-91(2005).

¹⁴ Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?*, 12 J. BUS. & RES. 193, 194 (2014).

¹⁵ Lamba A., Miranda B., *The Role of Executive Stock Options*, 10 INT’L REV. FIN. 339, 363 (2010).

transactions in order to figure out the ideal ratio.¹⁶ Such ideal ratios are considered to be more conducive for the companies.¹⁷ Finally, the difference in the rates of dividends and capital gain taxes also play a role of motivator for a company's decision to opt for share repurchase as an alternative for dividend distribution.¹⁸

1.2. Advantages of stock repurchases

One of the main advantages of stock repurchase transactions is the increase that they cause in Earning Per Share (EPS). Share buybacks are perceived as a crucial element for the management of the company's balance sheet.¹⁹ When the company acquires shares from its shareholders the number of the outstanding shares decreases but the value of the company does not change so the EPS will automatically increase. Imagine that the number of company A's outstanding shares is 100 each traded at \$10 and the company has \$100 of net profit that it wants to return to shareholders. If company A now repurchases 10 shares at \$10 each, then the aggregate value of the remaining 90 outstanding shares will be \$900; in other words, again stock is traded at \$10 per share. Thus, the EPS rate of company A will be \$1.1²⁰ per share, what by \$0.1 is more than EPS figure that would be in case of distribution \$100 as dividends. This means that the higher the EPS, the higher the market price of the shares of the company. Legal entities with higher EPS rate are considered to be "viewed more favorably" by investors than those with lower EPS.²¹ For the shareholders, higher EPS is an indicator of higher profitability of the company which is directly proportional to their potential rewards. Also, EPS is considered to be "the most quoted accounting item in the annual reports of business entities,

¹⁶ Reimers J. L., Singleton C. J., *Accounting meets strategy*, 91 STRATEGIC FINANCE 46-51 (2010).

¹⁷ Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?*, 12 J. BUS. & RES. 193, 194 (2014).

¹⁸ WILLIAM J. CARNEY, CORPORATE FINANCE 743 (2005).

¹⁹ Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?*, 12 J. BUS. & RES. 193, 193 (2014).

²⁰ The calculation of EPS of the company A after the stock repurchase transaction should be the following: \$100/90 shares=\$1.1.

²¹ Walker C., *Buybacks: Who wins?* 10 MONEY 82 (2011).

primarily because investors are very much interested in the effect of such report of EPS on the market prices of stock.”²² New investors purchasing shares of the company contribute to the equity capital of the company or in other words, bring new sums of money into the company that cannot but be beneficial both for the company and its shareholders.²³

Another advantage of stock repurchases is that such transactions signal to the public that the shares of the company may be undervalued by the market.²⁴ It is undeniable that the management of the company is better than anyone else at being aware about the ongoing business of the company and is expected to make its choice in favor of what is in the best interest of the company and its existing shareholders.²⁵ Therefore, its decision to invest in its own stock signals to the public that a new investment-friendly era is approaching. Nevertheless, some financial scholars dispute the increase in EPS as an indicator of a successful business because in case of stock repurchase transactions EPS growth is an outcome of a simple arithmetical formula with replaced variable for the number of outstanding stocks.

One more popular advantage of stock repurchases is the lower tax rate given that stock repurchases are normally taxed more favorably compared to distribution of dividends. Generally, in most jurisdictions, the rate of the income tax (which is deducted in case of the declaration of dividends) is less than the taxes deducted from capital gain (which appears in case of stock repurchase transactions). As it was mentioned in the example above related to the increase in EPS, after the stock repurchase transaction, the value of the company A’s share increased by \$1 per share which totally is \$100. Therefore, \$100 is a capital gain upon the outstanding shares of the company A. Gained \$100 will be taxed not upon their consummation

²² Horan M., *Are buybacks increasing EPS?* 78 CANADIAN BUSINESS 90-91 (2012).

²³ *Ibid.*; Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?*, 12 J. BUS. & RES. 193, 194 (2014).

²⁴ JEFF MADURA, FINANCIAL INSTITUTIONS AND MARKETS 253 (2008).

²⁵ Smith A.K., *A bigger slice of profits*, 60 KIPLINGER’S PERSONAL FINANCE 20, 20-22 (2006).

to the shares' value but upon the realization (sale) of the shares. In other words, the tax advantages for opting for share repurchase over dividend distribution are: (i) less rate of the capital gains tax and (ii) later date for the deduction of the taxes.

1.3. Disadvantages of stock repurchases

As practice shows increase in EPS due to execution of stock repurchase is not always a sign of a prosperous business. Sometimes, EPS can be manipulated through share repurchase transactions in order to artificially boost the value of the company's shares. EPS increase after stock repurchase is formed without any real increase in the earnings of the company.²⁶ For example, stock repurchase strategies of many pharmaceutical companies cover a big part of their earnings ("generated from high drug prices") and "in the name of maximizing 'shareholder value' (MSV)" contribute to the "sole purpose of manipulative boosts" in the value of the company's stock.²⁷

Another drawback of stock repurchases is that, as was mentioned earlier, in many companies the representatives of the senior management within their compensation packages are usually given stock options whereby they get the right during some period of time to request from the company to purchase a certain number of their shares. Frequently, before the execution of the options, the management of the companies decide firstly to implement share buybacks. As a result of repurchasing the EPS will increase, and so it will be more profitable for the representatives of senior management to realize the options after increased EPS.²⁸ The reason for profitability is that stock option provisions in employment or other contracts concluded between company and the representatives of senior management are usually arranged with a

²⁶ Rammohan R. Yallapragada, *Stock Buybacks: Good Or Bad For Investors?*, 12 J. BUS. & RES. 193, 196 (2014).

²⁷ WILLIAM LAZONICK, MATT HOPKINS, KEN JACOBSON, MUSTAFA ERDEM SAKINC, ONER TULUM, *US PHARMA'S FINANCIALIZED BUSINESS MODEL 2* (2017).

²⁸ Sanford, J., *Taking a little back*, 78 CANADIAN BUSINESS 90-91(2005).

fixed price at which the shares of company will be acquired upon the execution of the granted option. Therefore, the increase in the market price of the share due to the increase of EPS does not affect the price at which the holder of the option buys them.

Some scholars also argue that money spent by the companies for the implementation of their share buyback programs could be used in more profitable ways (e.g. expansions of the business, acquisition of new equipment, hiring new personnel, or diversification of the company's activity spheres). However, I opine that this is not a specific drawback of share repurchase because distribution of dividends also reduces the company's available cash and thus, limits the potential for the future expansions of the company. In addition, it should be taken into consideration that one of the primary goals of any commercial legal entity is to generate profit and give part of it to the shareholder as a return of their contributed capital. Therefore, it is reasonable to think that how companies spend their money depends on their business policies and strategies and regular returns to the shareholders are expected by investors to be included in such business strategies.²⁹

1.4. Methods of stock repurchases

Literature, generally, mentions more methods of stock repurchase.³⁰ The number usually differs depending on whether stock repurchases through 'fixed price tender offer' and 'Dutch

²⁹ For example, in *Dodge v. Ford Motor Co.*, the Supreme Court of Michigan held that although the decision of the Board of Directors of Ford Motor Company was to stop payment of special dividends and put all excess money "back into the nosiness for the purpose of extending its operations and increasing the number of its employees", the company should have decided upon distribution of some portion of profits to the shareholders. The reasoning was that: "A business corporation is organized and carried on primarily for the profit of its stockholders. The powers of the directors are to be employed for that end."

Although the case is about distribution of dividends rather than share buybacks, an example of this case, in my opinion, shows that return of the net profits to the shareholders is not always a drawback and that it is a *sine qua non* for the ordinary operation of any for-profit legal entity.

See. *Dodge v. Ford Motor Company*, 204 Mich. 459, 170 N.W. 668 (Mich. 1919).

³⁰ Report on "Stock Repurchase Programs", Technical Committee of the International Organization of Securities Commissions OICU-IOSCO 4-5; Theo Vermaelen, *Share Repurchases*, 8 FOUNDATIONS AND TREND IN FINANCE 170, 173 (2010); WILLIAM J. CARNEY, CORPORATE FINANCE 744 (2005).

‘auction’ are presented as different methods or categorized under one method called ‘self-tender offer’.³¹ If take them separately, there are five methods that can be differentiated: (i) purchase on the market, (ii) purchase through fixed price self-tender offer, (iii) purchase through Dutch auction, (iv) targeted repurchase of stock and (v) repurchase involving derivatives. The last method is quite complicated and itself includes different methods. As the purpose of the present section is to familiarize the reader with generally available methods, the following will only focus on the first four methods.³²

The first method is a repurchase of stock on the market, whereby a company repurchases its stock directly from the open market usually through brokers. Ordinarily, the special stock repurchase programs of companies last for a long period of time usually because of a large number of shares that a company expects to buy back. Furthermore, repurchase of the stock on market does not impose any obligation on the company to complete buyback because such repurchase transactions happen based on the will of the company without any prior-agreed conditions. In other words, the company acts in the shoes of an ordinary investor. One of the positive sides of buyback through the open market is purchase at the market price without any necessity to pay premium that is usually needed when other methods are resorted to. Nevertheless, some rules and regulations should be observed. For example, New York Business Corporation Law and New York Penal Law state that repurchase of the shares by issuer when there is no surplus, violates both civil law³³ and criminal law.³⁴

Another, quite frequently used repurchase method is when the issuer company makes a public offer to purchase back a certain number of the shares of stock (purchase through a ‘self-tender’

³¹ *Ibid.*

³² The thesis opts for categorizing ‘Dutch auction’ and ‘fixed price tender offer’ as separate components of one method – ‘self-tender offer’.

³³ New York Business Corporation Law, ss. 513, 514.

³⁴ New York Penal Law, s. 135.35(e).

offer.). Self-tender offer can be targeted (selective) or non-targeted. Non-targeted type itself can be:

- 1. Fixed price tender. Such offer specifies the quantity of stocks, the date and price at which shares will be bought back. Usually the price shown in the tender-offer includes the premium of the market price of the share. After the offer is made, interested stockholders can sell their shares.
- 2. Dutch auction. This method specifies only a price range within which the company will repurchase. Usually the supposed minimum price for share is higher than the current market price. Afterwards, based on the offers of the shareholders, the company makes a demand curve.³⁵ The purchase price is usually the lowest price that allows the firm to buy the desired quantity of shares. The important advantages of Dutch auction are that it becomes possible for the company to get information about buyback price directly from stockholders and that through this method stock repurchase programs can be completed during a shorter time period.³⁶

One more method is a targeted repurchase of stock (a.k.a. “selective buybacks”). In this scenario, the offer is made directly to one or more shareholders to repurchase their shares (usually, the purchase price includes premium). The advantage of this method is that the company negotiates directly with certain shareholders, what usually leads to the higher cost-effectiveness. However, such negotiations can also last for a long time what is a negative side of this method.

³⁵ After the offer is made, shareholders make their bids indicating the number of shares and price at which they want to sell. Then, company analyzes the obtained bids and determines appropriate prices at which the shares will be acquired.

³⁶*What are stock buyback methods?*, CORPORATE FINANCE INSTITUTE (March 27, 2020, 03:15 PM), <https://corporatefinanceinstitute.com/resources/knowledge/strategy/stock-buyback-methods/> .

One point to be considered here is the legality of selective stock repurchase. As it is seen from the nature of the term, company willing to execute selective buyback is treating shareholders not in the same way by making offers to some but not to all of them. This raises the question of discrimination and fiduciary duties of the BOD of the company vis-à-vis shareholder which was not included into the selective buyback program. For this reason, in some states such as Brazil, Germany, Malaysia, Italy and Switzerland ‘selective’ buybacks are not permitted.³⁷ In the USA, generally, selective buybacks are allowed,³⁸ “provided the directors have not acted out of a sole or primary purpose to entrench themselves in office.”³⁹ For example, upon some conditions whereby a takeover threat occurs, BODs can decide to implement selective share buybacks. In 1985, the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*, applied business judgement rule to the takeover defense strategies.⁴⁰ The court held that selective stock repurchase transactions can be implemented if “there was a threat to corporate policy and the defensive measure adopted was proportional and reasonable given the nature of the threat.”⁴¹

1.5. Historical development of the regulations on stock repurchases in the US and Azerbaijan

Before the commencement of the 2019 economic depression share only a few corporations bought their outstanding shares, however, during the market meltdown a lot of companies started to purchase their own stock in order to increase the share value.⁴² One of the initial negative reactions to such a practice of companies was made by the Governing Committee of

³⁷ Report on “Stock Repurchase Programs”, Technical Committee of the International Organization of Securities Commissions OICU-IOSCO 9-10.

³⁸ *Ibid.* at 10

³⁹ DAVID KERSHAW, *COMPANY LAW IN CONTEXT: TEXT AND MATERIALS* 406 (2012).

⁴⁰ *Unocal Corporation v. Mesa Petroleum Company.*, 493 A.2d 946 (Del. 1985).

⁴¹ *Ibid.* at 951

⁴² Stephen Mihm, *How Stock Buybacks Ambled into Stardom*, BLOOMBERG OPINION, (May 2, 2020, 05:15 PM), <https://www.bloomberg.com/opinion/articles/2019-07-24/stock-buyback-history-is-a-mess> .

the New York Stock Exchange, which incited companies not to trade in their shares.⁴³ Further, in 1934, the Securities and Exchange act was adopted. The language of the act was very vague so that one could come to the conclusion that trading in its own shares would be qualified as market manipulation.⁴⁴ The next important document on the development of the regulation in the sphere of stock repurchases was Williams Act passed by Congress in 1968,⁴⁵ where it stated that “[t]he shareholder of a company and other persons interested in the market price of its stock should have full information regarding the company’s activities and intentions in repurchasing its own stock.”⁴⁶ Thus, the regulation of stock repurchases was strengthened.

In 1981, Ronald Reagan won the presidential elections and from then on a new wave of deregulations started. With regards to the stock buybacks, in 1982, the Securities Exchange Commission issued Rule 10b-18, according to which a new ‘safe harbor’ was created. According to it, the mandatory disclosure requirement fixed in the above mentioned bill was changed to be voluntary,⁴⁷ and this meant that neither SEC nor ordinary investors could anymore determine whether the company has disclosed all information regarding the potential stock repurchase. Since the issuance of Rule 10b-18, no company has been prosecuted for the implementation of abusive stock repurchase transactions.⁴⁸ Taking this into consideration, it seems reasonable to say the establishment of ‘safe harbor’ created a more auspicious environment for implementation of stock repurchases, which in turn has been conducive for the present popularity of share buybacks.

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ Codified in sections 13(d), 13(e), 14(d), 14(e), and 14(f) of the Securities Exchange Act of 1934.

⁴⁶ S. 510, 90th Cong. § 13, § 14 (1967).

⁴⁷ US SEC’s Division of Trading and Markets, *Answers to Frequently Asked Questions Concerning Rule 10b-18 ("Safe Harbor" for Issuer Repurchases)*, (May 2, 2020, 10:00 PM), https://www.sec.gov/divisions/marketreg/r10b18faq0504.htm#P15_1144 .

⁴⁸ Stephen Mihm, *How Stock Buybacks Ambled into Stardom*, BLOOMBERG OPINION, (May 2, 2020, 05:15 PM), <https://www.bloomberg.com/opinion/articles/2019-07-24/stock-buyback-history-is-a-mess> .

With regards to the development of the regulation on share buybacks in Azerbaijan, it is worth mentioning that indeed the legislation of Azerbaijan in this regard has not passed a long and complicated path. The relevant single provision concerning stock repurchases was included into the Civil Code of Azerbaijan in 2003.⁴⁹ This provision fixed the mechanism for the implementation of stock repurchases in the legislation, introduced some purposes for which stock repurchases could be implemented (namely, decrease of the number of outstanding shares and the amount of charter capital), listed the situation when share buybacks are prohibited.⁵⁰ The next important documents were two Resolutions of Constitutional Court of Azerbaijan, where the court dealt with taxation imposed on share buybacks⁵¹ and the appraisal rights of dissenting shareholders⁵² respectively. In comparison with the US, in the legislation of Azerbaijan, there has never been norms requiring disclosure upon implementation of stock repurchase transactions. In addition, the article 78 of Law of Azerbaijan on Securities Market, which determines the situations that should be qualified as abusive actions in securities markets, does not define share buybacks as a type of market manipulation.⁵³ Hence, one can argue that, bearing in mind there are no norms requiring disclosure or any other monitoring tools, the legislation of Azerbaijan generally creates favorable conditions for the implementation of share buybacks. Nevertheless, I opine that the correct perception of the

⁴⁹ AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESINDE ELAVELER VE DEYISHIKLIKLER EDILMESI HAGGINDA AZERBAIDGAN RESPUBLIKASININ QANUNU [The Law of the Republic of Azerbaijan on the Amendments and Additions to the Civil Code of the Republic of Azerbaijan] AZERBAIDGAN RESPUBLIKASININ GANUNVERIDJILIK TOPLUSU [Azerbaijan Republic Collection of Legislation] 2004, No. 3, Item 123; *See*. AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 105-1 (Republic of Azerbaijan).

⁵⁰ *Ibid*.

⁵¹ Azerbaidgan Respublikasinin Konstitutsiya Mehkemesi Plenumunun 7 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 7, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

⁵² Azerbaidgan Respublikasinin Konstitutsiya Mehkemesi Plenumunun 16 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 16, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

⁵³ GIYMETLI KAGHIZLAR BAZARI HAGGINDA AZERBAIDGAN RESPUBLIKASININ QANUNU [The Law of the Republic of Azerbaijan on Securities Market] AZERBAIDGAN RESPUBLIKASININ GANUNVERIDJILIK TOPLUSU [Azerbaijan Republic Collection of Legislation] 2016, No. 11, Item 1756.

nature of stock buybacks also plays significant role for their gaining in popularity. For this reasons, the next chapter focuses mainly on the treatment of stock buybacks as an alternative for dividend payout.

Chapter II. Stock repurchase as an alternative of dividend distribution

2.1. The economics of ‘stock repurchase v. dividend payout’

Although stock repurchase and dividend payout are different procedures, it is undeniable that for the shareholders, assuming there are no taxes, the economic effect of stock repurchases is basically the same as that of dividend payouts. For example, imagine that the market value of company A's outstanding stock is \$10000, each out of 100 shares trading at \$100. Also, \$1000 out of \$10000 is the cash surplus. Two following scenarios can be proceeded in order to return the surplus to the shareholders:

1) Assume that A distributes \$1000 cash surplus as dividend at \$10 per share. As a result, the shareholder X who holds 50% of company now has (i) \$500 in cash⁵⁴ and (ii) 50 shares with value of \$4500;⁵⁵ \$5000 in total.

2) Assume that A decided to return profit to the shareholder through stock repurchase. A buys the shareholder X shares for the total value of \$1000. As a result, the shareholder X now has (i) \$1000 in cash⁵⁶ and (ii) 40 shares with value of \$4000;⁵⁷ \$5000 in total.

As it is seen, assuming there are no taxes, in both above mentioned scenarios the shareholder again has \$5000 in total just the value of owned cash on shares is different. Economic effect is felt when corresponding taxes are deducted. The rates of dividend tax, short-term capital gains and long-term capital gains tax are usually different and having various ways to distribute profits to the shareholders with different tax advantages gives room for the companies to make flexible business strategies.

⁵⁴ Shareholder X with 50% has 50 shares with \$10 return for each. Therefore, total return from declared dividends will be $\$10 \times 50 = \500 .

⁵⁵ The value of 50 shares after the distribution of dividends is $(\$10000 - \$1000) \times 50\% = \$4500$.

⁵⁶ 10 shares of the shareholder X were acquired at \$100 per share, what is $10 \times 100 = \$1000$.

⁵⁷ As a result of repurchase the number of outstanding shares of the company decreased to 90 shares. The value of 40 shares after stock repurchase is $(\$10000 - \$1000) / 90 \times 40 = \$4000$.

2.2. The functional perception of stock repurchases

2.2.1. Interrelation of dividends and stock repurchases in the selected jurisdictions

Dividend is defined in the Tax Code of Azerbaijan as a payment made to the shareholders from the net income of the company and also payment made in accordance with stock repurchase program where the value paid is not more than the aggregate nominal value of the acquired shares.⁵⁸ As in almost all other jurisdictions, if the value of the net assets of JSC is less than the amount of the charter capital or will be less as a result of paying the dividends, JSC is not allowed to declare and pay dividends.⁵⁹ Similar rule can be found, for example, in New York Business Corporation Law (NYBCL)⁶⁰ or in Delaware General Corporation Law (DGCL).⁶¹ In addition, NYBCL and DGCL also contain insolvency-preventing rules regarding the execution of stock repurchases, which is absent in the legislation of Azerbaijan. The only conditions upon the occurrence or existence of which share buybacks cannot be implemented in Azerbaijan are: (i) incomplete formation of the charter capital of the company, (ii) the adoption of a resolution upon dissolution of the company and (iii) when the previous share buyback program was not completed.⁶² Absence of the rule preventing the share buybacks when a company is insolvent or does not have surplus or net assets also to some extent indicates that the legislation of Azerbaijan does not treat share repurchases as a tool to distribute profits of the company to its shareholders.

⁵⁸ AZERBAIDGAN RESPUBLIKASININ VERGI MEDJELLESİ [AR VM] [Tax Code] art. 13.2.15 (Republic of Azerbaijan).

⁵⁹ AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 106-3.9 (Republic of Azerbaijan).

⁶⁰ New York Business Corporation Law § 510 (1890).

⁶¹ Delaware General Corporation Law, § 160 (1953).

⁶² AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 105-1.4 (Republic of Azerbaijan).

In *Morris v. Standard Gas & electric Co.*, the plaintiff was alleging capital impairment as a reason to invalidate the payment of dividends.⁶³ The Delaware Court of Chancery found that, as a result of discussions with professionals about the financial reports of the company, the BOD of the defendant had determined excess of the net assets over the minimum surplus requirement.⁶⁴ The court also stated that there was no single standard for evaluation of assets and that the BOD was entitled to evaluate the assets “on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present ‘values.’”⁶⁵ In other words, the court held that there is no fraud or bad faith, where the circumstances show that directors had taken “great care to obtain data”, the BOD is entitled to revalue the assets to show the required surplus.⁶⁶ In *Klang v. Smith’s Food & Drug Centers* decided in 1997, the Supreme Court of Delaware, on appeal from the Court of Chancery, was faced with the claim of the plaintiff about the invalidation of stock repurchase due to the capital impairment.⁶⁷ The court referred to the decision in *Morris v. Standard Gas & electric Co.* and stated that the right of the BOD to revalue the assets in order to show the surplus are also applicable for the determination of surplus in case of stock repurchase.⁶⁸ Hence, these two cases illustrate the equal function of the ‘surplus’ for the purposes of both stock repurchase and distribution of dividends.

In 2011, the 1st Administrative-Economic Court of the capital Baku addressed the Constitutional Court of Azerbaijan (CCAR) for the preliminary ruling upon the interpretation of article 13.2.15 of Tax Code, which gives definition of dividend. One of the questions raised by the 1st Administrative-Economic Court of Baku was on how “other forms of distributions”

⁶³ *Morris v. Standard Gas & Electric Co.*, Del.Ch., 63 A.2d 577 (1949).

⁶⁴ *Ibid.* at 584-585.

⁶⁵ *Ibid.* at 582.

⁶⁶ *Ibid.* at 585.

⁶⁷ *Klang v. Smith’s Food & Drug Centers*, 702 A.2d 150 (Del. 1997).

⁶⁸ *Ibid.* at 155.

included into the definition of dividend should be understood for the purposes of taxation.⁶⁹ In drawing the distinction between dividends and stock repurchases, CCAR started its analyses introducing the paraphrased version of the article 106-3.5 of the Civil Code, which states that the decision on dividends and rules of their payment in cases when it is not specified in the Charter shall be made by the BOD of the Company or, if this body has not been formed, upon the suggestion of the executive body, by the GM.⁷⁰ Then, CCAR stated that from the essence of this article it is seen that while dividends are distributed among shareholders, usage of net income to increase the nominal value of the shares through share buybacks does not consider any direct payment to the shareholders.⁷¹ For this reason, CCAR concluded that neither the concept of dividend nor the concept of ‘other distributions’ (included into the definition of dividend) encompass “the payment made in accordance with stock repurchases to increase the nominal value of the shares”.⁷² In other words, although the definition of dividend includes various types of distributions to the shareholders, CCAR interpreted so that it does not cover profit distributions through stock repurchase transactions. I consider that such an interpretation is to some extent erroneous not because stock repurchases should be included into the definition of dividends for taxation purposes, but because CCAR, by the mentioned Resolution, introduces ‘stock repurchases’ as something completely different and not related to the ‘distributions for shareholders’.

Opposite to the view of CCAR, as it was many times mentioned, one of the main objectives of share buybacks is mere return of the certain portion of profits to the stockholders. For example,

⁶⁹ Azerbaidgan Respublikasının Konstitutsiya Mehkemesi Plenumunun 7 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 7, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

⁷⁰ *Ibid*; AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 106-3.9 (Republic of Azerbaijan).

⁷¹ Azerbaidgan Respublikasının Konstitutsiya Mehkemesi Plenumunun 7 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 7, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

⁷² *Ibid*.

the US MBCA – which was adopted by twenty-four states – does not contain ‘dividend’ or ‘share buyback’ and instead uses the word “distribution”, which is defined as a “transfer of money or other property...to or for the benefit of its shareholders.”⁷³ Such formulation is used in order to cover both dividends and stock repurchases because “for creditors, share repurchases perform precisely the same function as dividends, by causing the corporation to pay funds to its shareholders.”⁷⁴ Furthermore, the civil legislation of Azerbaijan introduces stock repurchases primarily as a means to decrease the number of outstanding shares or the nominal value of the charter capital of the company.⁷⁵ Taking this into consideration, it is reasonable to say that the legislation of Azerbaijan recognizes stock repurchases mainly for their mechanical effect, rather than functional similarity with dividends.

2.2.2. Dividend and capital gain taxation in Azerbaijan

Usually, the long-term capital gain tax rate is lower than the dividend tax rate. One of the main reasons why stock repurchase is treated as an alternative for the dividend is the availability of lower short-term capital gain tax rate. In Azerbaijan, there is no special tax for capital gains. The tax imposed upon capital gain is the object of the income tax which is also deducted for the increase in the value of the shares.⁷⁶ Hence, in Azerbaijan the dividend tax rate is 10%,⁷⁷ the individual income tax rate is 14%,⁷⁸ and income tax rate for legal entities is also 20%.⁷⁹ As the figures show, if a company in Azerbaijan opts for stock repurchase, the shareholders’ final income will be 10% less than if it would opt for distribution of dividends. This also to some

⁷³ WILLIAM J. CARNEY, *CORPORATE FINANCE* 743 (2005).

⁷⁴ Model Business Corporation Act § 1.40(6) (2016).

⁷⁵ AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 105-1.2 (Republic of Azerbaijan).

⁷⁶ AZERBAIDGAN RESPUBLIKASININ VERGI MEDJELLESİ [AR VM] [Tax Code] art. 122.1, art. 96.5 (Republic of Azerbaijan).

⁷⁷ *Ibid.* at art. 122.1.

⁷⁸ *Ibid.* at art. 101.3.

⁷⁹ *Ibid.* at art. 105.1.

extent illustrates that the legislation of Azerbaijan does not treat stock repurchases as an alternative for the dividend payout. Otherwise, the difference in the rate would not be so abrupt.

In 2018, some amendments were made to the Tax Code, according to which new definition for ‘dividend’ was formulated.⁸⁰ New definition included payments made to the shareholders through stock repurchases but only within the volume of the portion of the nominal value which was increased based on the funds from the company’s net assets.⁸¹ In other words, the state started to impose taxation on the capital gain which is in the form of increase to the nominal value of the company’s charter capital. To make it simpler, assume that the market value of company A is \$1100 with 100 outstanding shares each traded at \$11 per share. \$100 out of \$1100 is net profits. Also, assume that previously the nominal value of 1 share was \$5 but last year the BOD of A decided to use net profits and increase the nominal value of 1 share by \$3. Now, company A wants to distribute net profits of \$100 through the repurchase of 9 shares. If it does so, \$3 for each share will be taxed at 10% because the amount of the increase in the nominal value of the repurchased shares was included into the definition of “dividend” which is taxed at 10%. The remaining \$5 (initial nominal value before increase) is exempt from taxation,⁸² whereas remaining \$2 (excess above the nominal value of 1 share maintained by the open market) will be taxed at 20% as an income. Thus, as a result of stock repurchase the shareholder company will finally receive: $((2 - 2 * 20\%) + (3 - 3 * 10\%) + 5) * 9 = \83.7 .

At first glance, it seems that by the Law on Amendments, the legislator goes beyond treatment of stock repurchase as an alternative for the dividends, and, for the purposes of taxation, even equates them. However, the increase in the market value of the repurchased shares will still be

⁸⁰ AZERBAIDGAN RESPUBLIKASININ VERGI MEDJELLESINDE DEYISHIKLIK EDILMESI HAGGINDA AZERBAIDGAN RESPUBLIKASININ QANUNU [The Law of the Republic of Azerbaijan on the Amendments to the Tax Code of the Republic of Azerbaijan] AZERBAIDGAN RESPUBLIKASININ GANUNVERIDJILIK TOPLUSU [Azerbaijan Republic Collection of Legislation] 2000, No. 8, Item 1.

⁸¹ AZERBAIDGAN RESPUBLIKASININ VERGI MEDJELLESİ [AR VM] [Tax Code] art. 13.2.15 (Republic of Azerbaijan).

⁸² *Ibid.* at art. 104.6; at art. 96.5.

taxed at 20% and in case of the repurchase of shares, the market value of which is much higher than their nominal value, the tax burden will also increase. Nevertheless, I opine that in absence of a separate short-term and long-term capital gain tax, treatment of the increase in the nominal value of shares as dividends is logical because it wouldn't be reasonable for the company to opt for the boosting the nominal value of shares if upon the realization of these shares the value funded from net profits of the company were taxed at a rate of income tax (20%), which is higher than the rate of the dividend tax (10%).

Thus, taking into consideration the above mentioned discussions, it seems reasonable to conclude that the legislation of Azerbaijan does not treat stock repurchases as an alternative for dividend payout. It introduces share buybacks just as a procedure which results in decrease of the number of outstanding shares and the amount of charter capital without paying due attention to its nature and economic effect. The next chapter discusses a narrower topic devoted to the evaluation of shares upon stock repurchases.

Chapter III. Evaluation of shares for the purposes of repurchase

3.1. Insight to the appraisal rights of shareholders

Admittedly, the decisions in companies are usually adopted by the majority of the General Meeting (GM) of shareholders upon the proposals of BOD.⁸³ In such cases, shareholders who have voted against the final decision usually have an opportunity to sell their shares in the open market and exit. In closed corporation shareholders do not have such an opportunity because no open market is available. Usually, shareholders who vote against the final decision do not exit, however, in some cases they do. The shareholder can resort to exit when, for example, he anticipates negative economic effect of the proposed decision on the value of the company or considers that the decision will result in non-payment of dividends.⁸⁴ Another example is when the company proposes to merge with another company or go through reorganization procedure and change the organizational-legal form of the entity.⁸⁵ Due to such reasons, shareholders are granted appraisal rights. For example, both MBCA and DGCL state that the shareholder dissenting from the approval of proposed merger may require the company to purchase his shares at fair value.⁸⁶ In Azerbaijan, such right, for the first time, was enlightened by the CCAR.⁸⁷

Appraisal rights occurred when the requirement for the unanimous consent of the shareholders was changed in the statutes to the consent of majority.⁸⁸ The objective of the new threshold was to assist the majority of shareholders in conducting various organizational changes which

⁸³ 'Decisions' in this context means those decisions which by statute, articles of incorporation or any other document are to be decided by GM, not BOD.

⁸⁴ EMIN KERIMLI, CORPORATE LAW OF AZERBAIJAN 197 (2014).

⁸⁵ *Ibid.*

⁸⁶ Model Business Corporation Act § 13.02 (2016); Delaware General Corporation Law tit. 8, § 262(b) (1953).

⁸⁷ Azerbaidgan Respublikasinin Konstitutsiya Mehkemesi Plenumunun 16 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 16, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

⁸⁸ BALLANTINE, CORPORATIONS 683-684 (rev. ed. 1946).

are required by the modern business environment and in decreasing dependence on the votes of minority.⁸⁹ In other words, the constitutionality of the decision adopted by the majority of shareholders, whereby the dissenting minority shareholders' votes do not matter for the final decision, was considered to be not fair⁹⁰ and appraisal rights were "invented" as a remedy for the dissenting shareholders.⁹¹

3.2. Fair value of the shares: perspective from Delaware and New York

As it was mentioned, 'fair value' is a price at which both MBCA and DGCL require the corporation to repurchase the dissenting shareholder's shares. If the dissenting shareholder is not satisfied with the price offered by the company, the purchase price should be maintained by the court or appraisers appointed by the court.⁹² Although the appraisal statutes are universal, some states such as California or New Jersey refer to 'market value' as 'fair market value'.⁹³ In this context 'fair market value' may mean either 'fair' market value (which means a market value that due to some modifications becomes fair) or 'fair market' value (which means the value proposed by the active fair market).⁹⁴ Apparently, 'fair market value' should be understood as something different from 'market value' because closed corporations' shares cannot be sold without being bound to comply with so onerous prior rules such as right of first refusal.⁹⁵ The reason is that the market for the shares of closed corporations is not public, not as deep and normally it is much harder to effectuate the sales. The drafters of the amendments, in result of which 'fair cash value' was changed into 'fair market value' state that new term

⁸⁹ *Remedies of Dissenting Shareholders under Appraisal Statutes*, 45 HARV L. REV. 233, 237, 248 (1931).

⁹⁰ BALLANTINE, CORPORATIONS 700-701 (rev. ed. 1946).

⁹¹ *Chicago Corporation v. Munds*, 20 Del. Ch. 142, 172 Atl. 452 (1934).

⁹² The report of the appraisers should further be subject to the court review. *See*. Model Business Corporation Act § 13.02 (2016).

⁹³ "These different expressions mean in effect the same thing." *See*. BALLANTINE, CORPORATIONS 704 (rev. ed. 1946).

⁹⁴ Harry L. Fledderman, *Corporations: Shareholders: Appraisal Rights: Compensation to Shareholders Dissenting from Mergers and Consolidations*, 40 CAL. L. REV. 140, 142 (1952).

⁹⁵ BONBRIGHT, VALUATION OF PROPERTY 830 (1937).

should be understood as price that is figured out taking into consideration not just a market price but also “evidence of average market quotations, sales, earnings [and] book value.”⁹⁶ Therefore, we again return to the term which is more widely used – ‘fair value’ or ‘value’ which is fair. The question arises how exactly the fair value should be determined? The commonly-accepted approach is that the concept of value and choice of measurement devices should be dependent on the purpose of appraisal; for instance, method of evaluation for taxation purposes is different because the objective is different from the one during merger.⁹⁷

Generally, courts in different jurisdictions have used three methods to determine fair value of the shares.⁹⁸ The first one is ‘net asset value’ which is usually determined based on the accounting books of the company. Such method was used, for example, in *American General Corp. v. Camp*, where the court stated that the dissenting shareholders should receive “the aliquot proportion which the number of shares held would be entitled to receive in the distribution of the net amount of the corporate funds in which his particular kind of stock would be entitled to receive.”⁹⁹ However, this authority does not seem to be strong because since its adjudication it has never been cited.¹⁰⁰ It does not seem reasonable to rely on the book value which is a mere accounting concept that illustrates how the assets and liabilities of the company are indicated in the balance sheet and has little influence on the economic value of the shares.¹⁰¹ Furthermore, during the merger or consolidation the target entity is not dissolved and that is why giving the dissenting shareholder value equal to the one that it would obtain if the company

⁹⁶ BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS 216 (1933 supplement).

⁹⁷ INTERNAL REVENUE CODE § 811 k, see U.S. Treas. Reg. 105, § 81.10, Cf. Note, 103 A.L.R. 955 (1938).

⁹⁸ Harry L. Fledderman, *Corporations: Shareholders: Appraisal Rights: Compensation to Shareholders Dissenting from Mergers and Consolidations*, 40 CAL. L. REV. 140, 143 (1952).

⁹⁹ *American General Corporation v. Camp*, 171 Md. 629, 190 Atl. 225 (1937). The similar approach was also utilized in *Petry v. Harwood*. See *Petry v. Harwood*, 280 Pa. 142, 124 Atl. 302 (1924).

¹⁰⁰ *State ex rel. Robbins v. Shellsburg Grain & Lumber Co.*, 243 Iowa 734, 739, 53 N.W. 2d 143, 145.

¹⁰¹ Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 8 AM. B. FOUND. RES. J. 875, 895 (1983).

was liquidated seems unfair.¹⁰² Nevertheless, the value of an asset is important when the liquidation value is expected to be greater than the value of going concern.¹⁰³ Such situations arise in appraisal proceedings related to the shares of the companies dealing with natural resources such as oil and gas.¹⁰⁴

The second method is the determination of the ‘market value’ that is considered to be fair. If a dissenting shareholder sells its shares on the open market after the dissented action was effected at a price equal to the one that was before the action took place, it is reasonable to say that the shareholder considers that those shares were no longer profitable investment and that the price of sale was adequate.¹⁰⁵ Therefore, it can be concluded that in a court proceeding to evaluate shares that was conducted before the dissented action took place, market price was the fair value of these shares. In *Matter of Marcus and Jones v. Healy*, the courts concurred in stating that worth given to the price determined by the market depends on how appropriately it reflects the will of informed buyer and seller.¹⁰⁶ In Delaware, the approach of the courts is not to give much weight to the market value,¹⁰⁷ which is “frequently out of line with true value.”¹⁰⁸ Also, taking into consideration that markets can approximate future actions and adjust prices accordingly, the proposal of dissented action can be a reason for the decline in share prices long before the action is approved.¹⁰⁹

¹⁰² The reason for such unfairness stated in *Matter of Seaich* was that asset value can be used to determine the value of a going concern if the goodwill and potential return on the investment are taken into consideration. See, *Matter of Seaich*, 170 Ap. Div. 686, 156 N.Y.S. 579 (1915).

¹⁰³ Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 8 AM. B. FOUND. RES. J. 875, 892 (1983).

¹⁰⁴ The following cases emphasized on the significance of asset value during the appraisal of natural resources as distinct from ordinary corporate assets. See, *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980); *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 505 (Del. 1981).

¹⁰⁵ *Valuation of Dissenting Minorities' Shares Under Section 21 of the New York Stock Corporation Law*, 17 FORDHAM L. REV. 259, 263 (1948).

¹⁰⁶ See, *Matter of Marcus (Macy & Co.)*, 297 N.Y. 38 (1948); *Jones v. Healy*, 55 N.Y.S. 2d 349 (1945).

¹⁰⁷ *Jacques Coe and Co. v. Minneapolis Moline Co.*, 75 A. 2d 244 (Del. 1950); *Chicago Corporation v. Munds*, 20 Del. Ch. 142, 172, Atl. 452 (1934).

¹⁰⁸ GRAHAM AND DODD, SECURITY ANALYSIS 26 (1934).

¹⁰⁹ Harry L. Fledderman, *Corporations: Shareholders: Appraisal Rights: Compensation to Shareholders Dissenting from Mergers and Consolidations*, 40 CAL. L. REV. 140, 144 (1952).

The third method to determine fair value applied by courts is the calculation of ‘investment value’, which means a value of capitalization upon future return of a stock.¹¹⁰ This method, to some extent, stipulates that a company that does not generate profits has low value. In the case, *Application of Behrens*,¹¹¹ (case from New York state where application of investment value was conducted), the court stated that appraisal should consider “market value, investment value and net asset value.”¹¹² In Delaware, the *Weinberger case*¹¹³ stated that the block method was “outmoded” because it did not use any other financial techniques known to the financial community besides market value, net asset value and investment value. The authority was so strong that after its adjudication, NYBCL was amended.¹¹⁴

3.3. ‘Liquidation’ versus ‘fair value’: Resolution of the Constitutional Court of AR

As it was mentioned before, in Azerbaijan, the appraisal right of dissenting shareholders was first discussed by the CCAR in its Plenum’s Resolution dated 16 December 2011. The proceeding was commenced by Shaki Appellate Court which addressed to the CCAR for the interpretation of articles 107-2.1¹¹⁵ and 107-5.1¹¹⁶ of the Civil Code. Prior to the proceeding, in 2009 “Mingachevir Construction” OJSC conducted GM of the shareholders where the

¹¹⁰ GRAHAM AND DODD, SECURITY ANALYSIS 531 (1934).

¹¹¹ *Application of Behrens*, 61 N.Y.S. 2d. 179, 182 (Sup. Ct. 1946), *aff’d mem.*, 271 App. Div.1007, N.Y.S. 2d. 910 (1st Dep’t 1948).

¹¹² *Ibid.* at 184. Another method where all mentioned three types of ‘value’ are used is in the so-called block method. *See.* Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 8 AM. B. FOUND. RES. J. 875, 892 (1983).

¹¹³ *Weinberger v. UOP, Inc.*, 457 A.2d 701, (Del. 1983).

¹¹⁴ *See.* New York Business Corporation Law § 623(h)(4).

¹¹⁵ Art. 107-2.1 states that the authorized quorum for the GM is the participation of the shareholders holding 60% of the company’s shares. *See.* AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 107-2.1 (Republic of Azerbaijan).

¹¹⁶ Art. 107-5.1 states that decision decisions about reorganization, liquidation, amendments and addendums to the charter are accepted by 2/3-majority vote of shareholders having voting rights in the general meeting. *See.* AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 107-5.1 (Republic of Azerbaijan).

proposal to reorganize the organizational-legal form of the entity from OJSC into LLC¹¹⁷ was approved. Only 25 shareholders out of 188 - who held 79,47% of all shares - participated.¹¹⁸ The shareholders who did not participate disputed the validity of the approval in the court of 1st instance which afterwards sought for the interpretation of some articles from the Civil Code. CCAR held that articles 107-2.1 and 107-5.1 do not contradict the property rights of minority shareholders because if the decisions adopted by the GM were required to be approved unanimously, then this would mean that minority shareholders are granted the right to put veto on any proposal before the GM. CCAR was of the opinion that such a rule would destroy the normal operation of the company. "Purchase of shares of JSC company do not entitle its holder 'to determine the fortune of the company' rather grants a mere right to participate in its governance."¹¹⁹ Further, CCAR recognizes appraisal rights of minority shareholders stating that although approval of a decision to reorganize is valid, the dissenting shareholders should be compensated. While it is logical that dissenting shareholders should be compensated, the question arises on how the value of compensation is to be determined. CCAR stated that the compensation should be equal to the liquidation value.¹²⁰ As it was mentioned earlier the liquidation value is based on the record from the balance sheet which does not introduce the real value of going concern. This method is usually used upon the dissolution or bankruptcy through liquidation. The essence of this method is that the company is winding up and is

¹¹⁷ The concept of LLC in Azerbaijan is different from that in US and is defined in article 87.1 of the Civil Code as a "company established by one or more persons (natural persons and (or) legal entity), the charter capital of which is divided into shares, the sizes of which are specified by the charter. Participants in a limited liability company shall not be liable for its obligations and shall bear the risk of losses associated with the activity of the company to the extent of the value of their contributions." *See. AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 87.1 (Republic of Azerbaijan).*

¹¹⁸ Azerbaidgan Respublikasinin Konstitutsiya Mehkemesi Plenumunun 16 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 16, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

¹¹⁹ *Ibid.*

¹²⁰ *Ibid.*

seeking for a quick sale of its assets.¹²¹ Furthermore, by reorganization, “Mingachevir Construction” OJSC did not cease to exist, it merely changed its organizational structure.

The same approach was held in Delaware, in *Harry Ng v. V. Heng Sang Realty Corp.* However, the Court of Appeal reversed the decision of the lower court proscribing the use of net asset value (liquidation value and net asset value are similar and based on the records from the balance sheet) as a sole method for determination of the value of going concern.¹²² The court here held that net asset value method can be used but only in conjunction with other methods.¹²³

Another example is from the state of New York, where the court in *Matter of Fulton*¹²⁴ stated that in order to compensate dissenting shareholders the assets should be valued from the view of a going concern not from the viewpoint of the company in liquidation.

Furthermore, as discussed above, different views and different methods are usually used to determine fair value at which the shares of dissenting shareholders should be repurchased, and I consider that a case-by-case approach should be used depending on the specific factual details and circumstances of the case. It seems meaningless to allege that concrete methods should be used without giving any reasoning. The objective of this paper is not to determine which valuation method should be given more weight but rather to argue that the CCAR erred applying ‘liquidation value’ as a result of which the dissenting shareholders obtained only liquidation value that is much lower than the fair value of the going concern.

¹²¹ EMIN KERIMLI, CORPORATE LAW OF AZERBAIJAN 202 (2014).

¹²² *Harry Ng V. Heng Sang Realty Corp.*, 2004 WL 885590 (Del. 2004).

¹²³ *Ibid.*

¹²⁴ *Matter of Fulton*, 257 N.Y. 487, 178 N.E. 766 (1931).

Conclusion

Stock repurchases are widely used in today's corporate business life in developed systems, and there can be different reasons to implement them. Particularly, for the purposes of the present thesis, treatment of stock repurchases as an alternative for dividends was analyzed. As illustrated in an example from the 2nd chapter, the possibility for such treatment is established by usually little difference in the rates at which dividend tax and short-term capital gains taxes are deducted. Azerbaijani legislation lacks separate capital gains tax (let alone short-term and long term ones), and a big difference between the rates of dividend tax and income tax (which is deducted upon realization of shares the value of which includes capital gain) prevents treatment of stock repurchase as an alternative for dividends. Also, unlike for dividends, for stock repurchases there is no 'surplus threshold' that should be taken into consideration. In other words, there is no norm in the legislation of Azerbaijan which would prohibit share buybacks that have potential to cause insolvency. Another point is that until the adoption of the Law on Amendments to the Tax Code,¹²⁵ stock repurchase was not even recognized as a method to distribute profits of the company to its shareholders. These reasons, in my opinion, are strong indicators to allege that the legislation of Azerbaijan does not see stock repurchase as an alternative for dividends.

With regards to the 'liquidation value' pronounced by the CCAR to be 'fair value' that should be paid to the dissenting shareholders,¹²⁶ I opine that such an allegation is weak because in case of reorganization, the company does not cease to exist but merely changes its external appearance. In reality, it still continues to be a going concern. Therefore, taking into

¹²⁵ AZERBAIDGAN RESPUBLIKASININ VERGI MEDJELLESINDE DEYISHIKLIK EDILMESI HAGGINDA AZERBAIDGAN RESPUBLIKASININ QANUNU [The Law of the Republic of Azerbaijan on the Amendments to the Tax Code of the Republic of Azerbaijan] AZERBAIDGAN RESPUBLIKASININ GANUNVERIDJILIK TOPLUSU [Azerbaijan Republic Collection of Legislation] 2000, No. 8, Item 1.

¹²⁶ Azerbaidgan Respublikasinin Konstitutsiya Mehkemesi Plenumunun 16 dekabr 2011-ci il tarixli Qerari [Resolution of the Plenum of Azerbaijan Republic Constitutional Court of Dec. 16, 2011] AZERBAIDGAN GEZETI [Az. Gez.] 2011.

consideration only the records from the balance sheet (that is what the liquidation value is based on) and ignoring future returns, in my opinion, is an erroneous way to achieve fair value.

Indeed, the resolutions of the CCAR are not recognized as a primary source of law.¹²⁷ However, the CCAR is the only body entitled to interpret statutes adopted by the legislative authority and in practice usually courts and executive bodies perceive such interpretations as the exact way how the legislative norms should be understood. In other words, such interpretations have a persuasive force. Currently, there is neither developed corporate law, nor an active capital market in Azerbaijan, and I consider that these are the reasons due to which no amendments were adopted yet to change this “imperative norm” established by resolution.

¹²⁷ The constitution of AR establishes the system and hierarchy of legislative acts in Azerbaijan. The types of legislative acts included in this system are considered to be mandatory and constitute primary sources of law in Azerbaijan. Resolution of CCAR are not included in this system. *See.* AZERBAIDGAN RESPUBLIKASININ KONSTITUSIYASI [KONST. AR] [CONSTITUTION] art. 148 (Republic of Azerbaijan).

Recommendations

Firstly, with regards to the legislation of Azerbaijan that does not treat stock repurchases as an alternative for the distribution of dividends, it would not be reasonable to say that there is a need to introduce separate capital gain tax. The reason is that the concept of capital tax gain and its long-term and short-term rates encompass not only increase in the value of shares but also many other types of gain such as precious metals, real estate and other valuable property. Revealing that flexible short-term capital gain tax is a strong factor for the treatment of stock repurchases as an alternative for the distribution of dividends is not enough to allege that such type of tax should be established and be imposed on other mentioned types of gain since the appropriateness of such type of tax for the current legal and economic situation in Azerbaijan is an issue that should be comprehensively investigated.

Nevertheless, the current position of the legislation of Azerbaijan also leaves much to be desired. My recommendation is to establish a separate type of tax directly imposed on increase over the share value caused by stock repurchase. The rate of such tax should be competitive with the dividend tax rate so that it gives a more flexible room for the company while considering which type of business decision to adopt for the purposes of distribution of net income to the shareholders (either to declare dividends or to repurchase stock).

The second recommendation is to add to the Civil Code of Azerbaijan new rules preventing capital impairment in case of stock repurchases. I consider that if the value of the net assets of JSC is less than the amount of the charter capital or will be less as a result of stock repurchase transaction, JSC should be prohibited from repurchasing its outstanding stock. Similar rule

already exists in relation to the allocation of dividends;¹²⁸ the idea is just to impose them also upon stock repurchases.¹²⁹

Another suggestion is to add to the Civil Code more descriptive provisions which will give precise definition for ‘share buyback’ and connected concepts, determine exact purposes for which share repurchases are usually implemented.¹³⁰ I believe a different stance of stock repurchases will also facilitate the growth of corporations and deepen the capital markets. For example, repurchasing its outstanding stock company signals to the public that there is a good area to invest. Companies usually try to invest in the most profitable businesses and a decision to put investment into its own shares can mean for investors that there is a business which worth to invest in.¹³¹ Of course, mere change of stance will not lead to an immediate breakthrough in capital markets of Azerbaijan but at least will make some contribution.

As far as the Resolution of the CCAR dated 16th December 2011 (whereby the value paid to the dissenting shareholders upon their appraisal right was pronounced to be equal to the liquidation value)¹³² is concerned, my suggestion is to amend the current legislation and add new rules stating that the appraisal of the shares should be conducted in such a way that not only the balance sheet, but also factual circumstances of the concrete case, specificity of business of the company and other various financial techniques were considered. From the cases mentioned in the third chapter in this regard, it is obvious that even in the States of Delaware and New York, there is no standard rule or generally applicable formula for the

¹²⁸ See. AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 106-3.9 (Republic of Azerbaijan).

¹²⁹ See the second chapter of the thesis where the capital impairment as a result of dividend payout was discussed.

¹³⁰ Two purposes for which share buybacks can be implemented (to decrease the number of outstanding shares and the amount of charter capital) already exist in the legislation. The idea is to extend the list by adding other important purposes such as to be an alternative for dividend payout. See. AZERBAIDGAN RESPUBLIKASININ MULKI MEDJELLESİ [AR MM] [Civil Code] art. 105-1.2 (Republic of Azerbaijan).

¹³¹ See the discussions set in the first chapter.

¹³² See the discussions set in the third chapter of the thesis.

evaluation of the fair value of the shares. Courts in these jurisdiction opt for ‘case-by-case approach’¹³³ and apply different financial techniques depending on many specificities of concrete cases. As was mentioned earlier, in some cases courts in the States of Delaware and New York applied either ‘net asset value’ or ‘market value’ or ‘investment value’ methods for the determination of fair value. Their decisions to opt for a particular method in particular cases were based on specificities of each situation and factual circumstances of the cases.¹³⁴ I opine the same case-by-case approach would also be beneficial in Azerbaijan.

Besides the mentioned suggestions on legislative level, I also recommend to give due attention to the education of people in the sphere of corporate finance and particularly, the treatment of share buybacks as an alternative for dividend payout. For example, the state may organize short-term training courses for potential shareholders, where fundamental principles of corporate governance and corporate finance will be taught. As a motivating element for attending such courses there may be reduced state fees for opening a joint stock company or registering the first tranche of shares. I believe that the state should be interested in increasing the degree of business education of those involved in the activities and operation of corporations, because it is undeniable that the more the investor is sophisticated, the less the probability for the investor to be a victim of fraudulent schemes and to seek help from courts and other governmental bodies. Also, such education should apply not only to business people themselves, but also to those who provide consulting services to them. Therefore, I believe that students specializing in business law and finance – who are likely and willful to engage in such consulting services in future – should have an opportunity to take appropriate courses related to corporate finance and corporate governance. Despite the volume of potential materials

¹³³ *Case-by-case*, CAMBRIDGE DICTIONARY, (May 13, 2020, 17:50 PM), available at <https://dictionary.cambridge.org/dictionary/english/case-by-case> (“Used to describe decisions that are made separately, each according to the facts of the particular situation.”)

¹³⁴ See the case discussions set in §3.2 of the thesis.

related to Azerbaijan in such courses is quite little, the practice and experience of foreign states with developed corporate sector and securities markets could be of great help.

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