California Law Review

VOL. 44

MARCH, 1956

NO. 1

Trading in Corporate Control

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I

A RECENT JUDICIAL LANDMARK AND ITS IMPLICATIONS

The complex issues springing from trading in corporate control were brought into sharper focus by the recent decision of *Perlman v. Feldmann*,¹ handed down by the Court of Appeals for the Second Circuit. The case posed the problem of whether a controlling shareholder or group who sells a control block of shares to outsiders at a price not made available to all shareholders may be compelled to pay over to the corporation or to other shareholders any premium in excess of the *investment* value of the shares.²

The litigation arose out of the following facts:³ The principal defendant, Feldmann, in August 1950, owned or controlled 398,927 or 37% of the outstanding shares of Newport Steel Corporation.⁴ The remaining shares, 735,117 in number, were owned by several thousand other shareholders.⁵

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¹ 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955). Chief Judge Clark wrote the majority opinion, which was concurred in by Judge Frank. Judge Swan wrote a strong dissent. See Notes, 40 CORNELL L.Q. 786 (1955), 68 HARV. L. REV. 1274 (1955); Comments, 22 U. CHI. L. REV. 895 (1955), 54 MICH. L. REV. 399 (1956).

² The term "investment value," frequently denominated "intrinsic value," is used to designate a capitalization of the estimated future return to be expected from the stock on the basis of presently available data. It is not necessarily identical with either actual market value or mere speculative value. It is tantamount, however, to the value which would be attributed to the stock on a hypothetical, well-informed market. For further details regarding the proper and inappropriate factors in such valuation, see text at notes 118-19 *infra*. See generally, GRAHAM AND DODD, SECURITY ANALYSIS 16-20 (3d ed. 1951); 1 BONBRIGHT, THE VALUATION OF PROPERTY 24-29 (1937); Application of Behrens, 61 N.Y.S.2d 179 (Sup. Ct. 1946), *aff'd*, 271 App. Div. 1007, 69 N.Y.S.2d 910 (1st Dep't 1947).

³ The facts stated unless otherwise indicated are based upon the findings of fact and opinion by Judge Hincks in 129 F.Supp. 162 (D. Conn. 1952), as well as the opinion in the court of appeals.

⁴ Feldmann, members of his family and his personal corporations owned 343,375 or 33% of the shares, which alone gave him working control. Another 55,552 shares were owned by his friends and business associates.

⁵ Although these outside shareholders constituted 63% of the voting power, they did not form a bloc and had no representatives on the board of directors. For that reason these shareholders may also be regarded as minority shareholders.

Feldmann, as controlling shareholder, not only was in effective command, but was also chairman of the board of directors and president of the corporation. Newport was engaged in the manufacture of steel sheets for sale to end-users of steel. In normal times Newport was a marginal producer, its predominantly outmoded facilities being in need of modernization. Except in times of extreme shortage, the corporation could not compete profitably with other steel mills for customers located outside its immediate geographic area. In previous periods of shortage, through the ingenuity of Feldmann, Newport had secured interest-free advances from prospective purchasers in return for firm commitments of future production. These advances were used to improve the existing plant and to acquire new facilities, thereby increasing the possibilities for profit.⁶

In 1950, as a result of the Korean War, steel sheets again were in extremely tight supply.⁷ Feldmann began to receive inquiries from persons interested in the possible purchase of a controlling stock interest in Newport. A group of geographically remote manufacturers of finished steel products, sensing the possibility of a deal, formed a syndicate for the purpose of purchasing his stock. The dominant motive for this action was to obtain a continuing source of steel sheet by gaining control of Newport. Feldmann knew this to be the motive of the purchasing group and during negotiations made available to them corporate information as to Newport's business, including productive capacity, advance commitments of output, and other data of the sort which normally would be furnished to the purchaser of a business.

The deal as finally concluded resulted in Feldmann's selling the control block of shares owned by him and his associates (37% of Newport's stock) to Wilport Company, a Delaware corporation, formed by the syndicate for the purpose of acquiring and holding the stock.⁸ The purchasers made an offer of \$18 per share, Feldmann asked \$22, and an agreement was reached at \$20, although the book value per share was \$17 and the over-the-counter price had not exceeded \$12.⁹ In compliance with the sale agree-

⁶ This method of financing was copied by other steel companies and became popularly known in the industry as the "Feldmann Plan."

⁷ Although government price control was not in effect, reputable steel producers, out of patriotic considerations, were not participating in the gray market brought about by the Korean War and were voluntarily refraining from advancing prices.

⁸ The purchasing group comprised sixteen manufacturing companies, all end-users of steel. They paid an aggregate of \$8,200,000 to Wilport to enable it to make the purchase, and received stock in proportion to their contributions. The syndicate members informally agreed among themselves that they would have the privilege of buying steel from Newport in proportion to their respective investments in Wilport. See 129 F. Supp. at 173.

⁹ Feldmann became committed to sell on August 24, 1950. On that date Newport stock was quoted on the over-the-counter market at 8½ bid, 9½ asked. Between August 28 and August 30, Feldmann purchased for members of his family and friends some 14,800 shares of

ment, at the closing, Feldmann transferred control of Newport by delivering resignation of all members of the board of directors and electing in their places nominees designated by Wilport.¹⁰ This change in management was made without notice to or consent of outside shareholders.¹¹ Newport proceeded to supply steel to members of the purchase group, such sales being made at Newport's posted prices and on its regular terms of sale.¹²

A derivative action was commenced by certain of the outside shareholders of Newport, naming Feldmann, members of his family, and associates as defendants.¹³ The theory of the complaint was as follows: the transaction was not a mere sale of stock but involved an unlawful sale of

Newport at prices ranging from \$9.69 to \$12 per share. The closing of the transaction took place on August 31, 1950, and the shares in question were promptly resold to Wilport at \$20 per share. Thus the "free" shares jumped in value when acquired by the control group. This sudden increase generates the crucial problems for the legal analysis of the right to the profit. Can it be said that control shares possess two value components: investment value and control value? In the particular situation, did the control component inhere in these shares or was it merely adventitious to the acquisition by Feldmann resulting from his control position? Would the shares have been shorn of their control value if again placed on the market by Feldmann? See note 61 *infra*.

¹⁰ It was important for the purchasers to obtain the immediate resignations of the officers and directors, so as to assure them of the power to command the uncommitted output as soon as possible. Most of Newport's contractual commitments terminated by December 31, 1950. The next annual meeting was almost six months away. In the meantime, it would have been legally possible for the old management to make commitments to others. 129 F. Supp. at 175.

Had the transfer of control been attempted through the call of a special meeting of shareholders, there would have been the danger of outside shareholders blocking the deal unless a general offer were made to all shareholders. Newport was an Indiana corporation. Under the Indiana General Corporation Act § 25-208, a majority of the remaining members of the board of directors had the sole power to fill a vacancy except that, in the case of a tie vote, the vacancy might be filled by vote of the shareholders at a special meeting.

¹¹ On September 14, 1950, following the take-over, Newport, through its new management, informed its shareholders of the purchase by Wilport of approximately 400,000 shares from the Feldmann group, the change in management and the names of the new board. Like information was contained in the 1950 Annual Report of Newport, released prior to the annual meeting held on February 19, 1951.

¹² The affiliation of Newport and Wilport, which lasted slightly over three years, appears to have been a marriage of convenience. Early in 1954, when the steel shortage had vanished and pending appeal from the judgment of the trial court, Wilport sold its controlling stock interest in Newport to Merritt-Chapman & Scott Corporation, controlled by Louis E. Wolfson. The transaction was effected by an exchange of one share of M-C & S common for each 2.1 shares of Newport common. The agreement required M-C & S to make a general offer on the same basis to all Newport shareholders and was contingent upon acceptance of the offer by 66% of Newport's outstanding shares. M-C & S succeeded in acquiring 94.7% of Newport's stock. The price of M-C & S common at the date of the offer was approximately \$22 per share, thereby yielding Wilport and other Newport shareholders about \$10.50 per share. See SEC Prospectus of Merritt-Chapman & Scott Corporation, dated January 27, 1954; MOODY'S INDUSTRIAL MANUAL 2646 (1955); 1953 and 1954 Annual Reports of Merritt-Chapman & Scott Corporation at pp. 19 and 24, respectively.

¹³ Most of the outside shareholders later disposed of their shares while the case was on appeal to the Second Circuit. See note 12 *supra*.

control. Feldmann, as director and dominating shareholder, stood in a fiduciary relationship to the corporation and to outside shareholders. Therefore, he could not utilize his command position to reap a personal advantage. The price paid for the stock included a premium for the sale of a corporate asset, namely, the power to determine the allocation of the corporate output in a period of short supply. This power was transferred by having Feldmann procure the resignation of his own board and install Wilport's nominees as part of the consummation of the transaction. Thus, the amount received in excess of market or investment value was actually a gray market premium which Feldmann had no right to appropriate. Defendants, on the other hand, took the position that the transaction was merely a sale of a controlling block of stock with such rights, powers and advantages as attached thereto. With the issue thus joined, District Judge Hincks stated his analysis of the crucial legal problem in the following terms:¹⁴

In the state of the steel market as it existed on August 31, 1950, was the admitted power inherent in a control block of corporate stock to control the distribution of Newport's product and to select those who may become its customers a corporate asset as the plaintiffs contend, or was it something properly pertaining to the ownership of a control block of stock the value of which was necessarily and properly reflected in the value of the stock as the defendants contend?

Giving judgment for defendants, the court rejected the corporate asset theory as advanced by plaintiffs and held that the power of a control block of stock to transfer management (and thereby of the distribution of the corporate output) was but "an attribute inseparably attaching to the stock which, if it has any effect on value, is an inseparable factor entering into the value of the control block."¹⁵ Proceeding on this basis, the district court found that the shares sold had a fair value as a control block of \$20 per share. But assuming separability of control from investment value, the court further noted: "What value the block would have had if shorn of its appurtenant power to control distribution of the corporate product, the evidence does not show."¹⁶ Thus, even if the control block could be dissociated from the attached power of control, plaintiffs had failed to sustain the burden of proving that the stock so isolated had a lesser value.

The court of appeals, with Judge Swan dissenting, rejected the non-separability doctrine, shifted the burden of proof as to the value components to defendants and remanded the case to the district court with instructions to ascertain what part of the purchase price was to be allocated

¹⁴ 129 F. Supp. at 183.

¹⁵ *Id.* at 182.

¹⁶ *Id.* at 179.

to the power to control the management and thereby to capture the corporation's product. Such "premium," the court determined, should be shared by defendants with plaintiffs to the extent of their respective stock interests. Moreover, rather than awarding recovery to the corporation, as is normally done in a derivative suit, the majority ruled that plaintiffs were entitled to recover individually,¹⁷ since the only alternative, with recovery for the corporation, would give the purchaser of the stock, or its successors, a windfall to which they clearly were not entitled.¹⁸

Although it is too early to forecast the full implications of *Perlman v. Feldmann* upon the development of the law in this area, the case calls for a broad reappraisal of the legal aspects of trading in corporate control. In attempting this re-evaluation, consideration will be given initially to the various legal doctrines which are presently thought to be applicable when corporate managers (including controlling shareholders) buy or sell the corporation's shares, including the scope and nature of the fiduciary duty imposed in connection with these transactions. Under the conventional approach, there appears to be an inclination to regard controlling shares as an ordinary asset which corporate managers may buy and sell with the same freedom which the law permits with respect to other kinds of property.

The validity of this general assumption as to the legal status of corporate shares will be tested by making an analysis of the economic factors which give to the control shares a special value in addition to the investment component. It will be seen that, quite apart from ownership of shares, control of the corporation, as such, is a valuable commodity. Moreover, it is possible to profit from trading in control, whether through the rather obvious device of relinquishing corporate offices or the more subtle method of a sale of shares. Accordingly, a broad examination of the cases is made to determine whether the traditional doctrine which seemingly denies accountability for profits attributable to the control component on the sale

¹⁷ According to the opinion: "Judgment should go to these plaintiffs and those whom they represent . . ." 219 F.2d at 178. Unfortunately it is not clear whether the outside shareholders who in the meantime had parted with their shares were nevertheless entitled to participate in the recovery. Moreover, some of those outside shareholders who had not parted with their shares might well not have joined or intervened in plaintiff's action on the assumption that any recovery would be awarded to the corporation and thereby inure to their indirect benefit. In view of these contingencies the proper procedure, after remand, should have been for the trial court to order that notice be given to all shareholders existing at the date of the transaction of their right to become parties to the action and share in any possible recovery. See text at notes 96-101 *infra*. See also, Note, 68 HARV. L. REV. 1274, 1277 (1955).

¹⁸ Wilport paid a premium for control in an arm's length transaction. It did not and probably would have been unable to recoup this expenditure on resale of the stock, after the steel shortage had ended. See note 12 *supra*. This indicates that the excess price actually represented a gray market premium for the acquisition of control over Newport's output.

of shares can be supported in the light of the current trend in the authorities to prevent abuse of power on the sale of control. We shall take into account especially: (1) doctrinal differences in current theory; (2) elements of corporate control which make it marketable; (3) appropriate bases of recovery under the emerging law; and, finally, (4) cracks in the judicial foundation for the traditional theory.

II

DOCTRINAL DIFFERENCES IN CURRENT THEORY

A.

Traditional Theory

The conventional approach is predicated upon the notion that the corporation—the collective body of shareholders—is a separate and distinct legal entity, an artificial personality,¹⁹ to whom an officer, a director or a controlling shareholder owes his sole duty. It follows as a corollary that the controlling shareholder is not a fiduciary of and owes no duty to the outside shareholders as individuals when he sells his stock to strangers.²⁰ To be sure, the separate entity theory serves a useful function by recognizing the corporation as a legal unit with capacity to hold property, make contracts, sue and be sued, continue to exist despite changes in shareholders and, in general, to provide a mechanism not only for shielding personal assets from the claims of firm creditors, but also to segregate firm assets for the protection of business creditors. Moreover, the doctrine of fiduciary duty to the corporation is a part of this system for protecting the various interests which have claims against the corporation.

This approach, however, which denies the existence of fiduciary obligations, within appropriate limits, to the individual shareholders as such, has gradually suffered judicial erosion. Thus, while the prevailing view was that a director might use important inside information in the purchase of his corporation's shares from an outside shareholder, even though he profited at the expense of the seller, the courts no longer accept this position in its

¹⁹ As the late Max Radin adroitly put it: "the corporate person is the Charlie McCarthy of the law since like a ventriloquist's dummy it merely seems to speak and the words it uses are really the words of its manipulator." Radin, *A Restatement of Hohfeld*, 51 HARV. L. REV. 1141, 1160 n.12 (1938). See also, Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643 (1932).

²⁰ Numerous cases accept this position. *Keely v. Black*, 91 N.J. Eq. 520, 111 Atl. 22 (1920); *Stanton v. Schenck*, 140 Misc. 621, 251 N.Y. Supp. 221 (Sup. Ct. 1931); *Levy v. Feinberg*, 29 N.Y.S.2d 550 (Sup. Ct. 1941), *rev'd sub nom.*, *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1st Dep't 1942); *Tryon v. Smith*, 191 Ore. 172, 229 P.2d 251 (1951); *Gallagher v. Pacific American Co.*, 97 F.2d 193 (9th Cir. 1938) (dictum); *Roosevelt v. Hamblin*, 199 Mass. 127, 85 N.E. 98 (1908) (dictum). Cf. *Delavan v. New York, N.H. & H. R.R. Co.*, 154 App. Div. 8, 139 N.Y. Supp. 17 (1912). See text at notes 108-19 *infra*.

sweeping generality. Either by developing a so-called "special-facts doctrine" or by recognizing the minority or "fiduciary rule," most courts have in substance created a duty directly to the selling shareholder, because only he, not the corporation nor the other shareholders, has been injured.²¹ It is important to note that here, as in many other areas of the law, the determination of the question to whom the recovery properly should be awarded really fashions the right.

Recognizing these developments, conventional theory holds that, whatever may be his fiduciary obligation when he *purchases* shares from shareholders, directly or indirectly,²² as a general rule the controlling shareholder nevertheless may *sell* to any person, at any time, and at any price.²³ Even when he assumes the additional role of officer and director, the controlling shareholder is said to be in a fiduciary relationship only to the

²¹ It seems unnecessary to do more than remind the reader of this problem, which is in many respects parallel to our main question. See BALLANTINE, *CORPORATIONS* § 80 (rev. ed. 1946); Berle, *Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827 (1927); Laylin, *The Duty of a Director Purchasing Shares of Stock*, 27 YALE L.J. 731 (1918). But see Walker, *The Duty of Disclosure by a Director Purchasing Stock from His Stockholders*, 32 YALE L.J. 637 (1923). Careful readers of the decisions know that the old "majority" rule is now not only generally discredited, but has been practically discarded. While some American courts may still pay it lip service, the cases back up the claim that the rule has actually been applied in unqualified form in only one or two occasions in the last thirty years. STEVENS AND LARSON, *CASES ON CORPORATIONS* 355 (2d ed. 1955). As Loss says: "In actual results the old 'majority' rule has substantially merged into the 'special circumstances' doctrine, which in turn is scarcely distinguishable from the so-called 'minority' rule." LOSS, *SECURITIES REGULATION* 825 (1951). It would be sheer folly to place faith in the older decisions in the face of overwhelming evidence that the courts are imposing a fiduciary duty upon officers, directors, and controlling shareholders to disclose inside information when purchasing shares from outside shareholders. *Hobart v. Hobart Estate Co.*, 26 Cal.2d 412, 159 P.2d 958 (1945); *Taylor v. Wright*, 69 Cal. App.2d 371, 159 P.2d 980 (1945); *Agatucci v. Corradi*, 327 Ill. App. 153, 63 N.E.2d 630 (1945); *Northern Trust Co. v. Essaness Theatres Corp.*, 348 Ill. App. 134, 108 N.E.2d 493 (1952); *Buckley v. Buckley*, 230 Mich. 504, 202 N.W. 955 (1925); *Blazer v. Black*, 196 F.2d 139 (10th Cir. 1952); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (common-law liability imposed upon parent corporation as controlling shareholder). For a more restricted view of the insider's exposure to liability, see Weisbrod, *Trading in Business Ownership*, 1954 U. ILL. L. FORUM 465, 466-74.

As to the effect of SEC Rule X-10B-5 on these transactions when purchases are made by use of the mails or the facilities of any national securities exchange, see *Speed v. Transamerica Corp.*, *supra*; *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). Cf. *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933). See generally, LOSS, *SECURITIES REGULATION* 827-44 (1951); Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROB. 505 (1953).

²² Where the corporate insider conceals his identity as the purchaser by the use of a straw man as agent he has been held to have breached his duty to disclose "special facts" and exposed himself to a common-law action of deceit. *Taylor v. Wright*, 69 Cal. App.2d 371, 159 P.2d 980 (1945) (purchase by controlling shareholder-director; exemplary damages awarded). See also *Barnes v. Eastern and Western Lumber Company*, 287 P.2d 929 (Ore. 1955), which holds that failure to disclose the insider's identity where purchasing shares from a fellow director is fraudulent, even though the agent's misrepresentation of the purchaser's identity was not authorized. Compare the "direct or indirect" wording in SEC Rule X-10B-5.

²³ See note 20 *supra*.

corporation in the management of its affairs and in dealings with or for the corporation (for he is then exercising a corporate function); but he is not a fiduciary with respect to his stock.²⁴ Accordingly, when playing this triple role, the controlling shareholder may exact a premium on the sale of controlling shares, since he is not regarded as having reaped an unlawful profit at the expense of the corporation.

Despite this apparent logic, there are a number of admitted limitations on the individual freedom of the controlling shareholder in disposing of his shares. The orthodox view of these restrictions was summarized by Mr. Justice Benvenga, in the lower court opinion in *Levy v. Feinberg*:²⁵

[I]t is well settled that a director-majority stockholder can be compelled to account to the corporation for an improper sale of his stock: (1) Where, in addition to the purchase price, he receives a bonus for relinquishing either his control or his office; (2) where, by a sale of his stock at a premium, he conspires fraudulently to turn over control to purchasers who mismanage the corporation; and (3) where, without adequate investigation, he negligently turns over control to purchasers who pay him a bonus for the sale of his stock, and the purchasers then proceed to loot the corporate assets. In short, he can be compelled to account where he receives a gain which can reasonably be traced to an *abuse of his controlling position*.²⁶

The theoretical bases of these exceptions are subject to considerable dispute. The "sale down the river" or looting cases may be explained upon the familiar tort principles of fraud and negligence, without the necessity of treating the controlling shareholder as a fiduciary.²⁷ Accordingly, the measure of damages is said to be injury to the corporation, not unjust enrichment to the seller of control.²⁸ Short of these limited exceptions, the

²⁴ Fletcher makes the following statement of the rule: "Ordinarily a director possesses the same right as any other stockholder to deal freely with his shares of stock and to dispose of them at such a price as he may be able to obtain, provided the director acts in good faith, since the corporation as such has no interest in its outstanding stock or in dealing in its shares among its stockholders. In other words, the mere fact that a man accepts the position of a director or an official in a corporation should not as a rule deprive him of his right to dispose of his stock as he sees fit and to make any profit that he might gain, provided in the sale of that stock he has done nothing to injure the corporation and its stockholders." 3 FLETCHER CXC. CORP. § 900 (perm. ed. 1947).

²⁵ 29 N.Y.S.2d 550, 556 (Sup. Ct. 1941), *rev'd sub nom.*, *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1st Dep't 1942). (Emphasis added.) See note 109 *infra*.

²⁶ Fletcher states the rule in almost identical language, except for the omission of the crucial last sentence. 3 FLETCHER CXC. CORP. 307 (perm. ed. 1947).

²⁷ This is the view taken by Judge Swan in his dissenting opinion in *Perlman v. Feldmann*. The leading looting case, *Insuranshares Corporation v. Northern Fiscal Corp.*, 35 F.Supp. 22 (E.D. Pa. 1940), was indeed decided on the tort theory, but the court added at page 28: "The duties and liabilities in such [a looting] case may be more than I have assumed them to be for the purposes of this case, but they are certainly not less."

²⁸ The measure of recovery is clearly different and may be cumulative. Thus in *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941), a looting case, the court found that \$1.25 per share

conventional view is that the controlling shareholder may sell his shares at the best price obtainable and retain for himself any premium over the going market or investment value.

B.

Current Doctrinal Controversy

The corporate asset theory, upon which plaintiff relied in the *Feldmann* case, was first advanced by A. A. Berle, Jr.²⁹ Apparently conceding the major premise that corporate managers (including controlling shareholders) stand in a fiduciary relationship solely to the corporation,³⁰ Berle contended that any premium paid for a majority block of stock is paid by the purchaser because the shares carry "control"; the purchaser is "buying power and not stock."³¹ Moreover, he argued, "the power going with 'control' is an asset which belongs only to the corporation; and . . . payment for that power, if it goes anywhere, must go into the corporate treasury."³²

The corporate asset theory as formulated by Berle has elicited strong opposition or at least has met with suspicion.³³ Thus it has evoked the emo-

or \$1,318,750 of the consideration paid for the controlling shares was received for transferring control by the substitution of directors. Defendants were held accountable to the corporation both for these special profits and for all damages naturally resulting from their official misconduct. *Gerdes v. Reynolds*, 30 N.Y.S.2d 755 (Sup. Ct. 1941), affirming the referee's report as to measure of tort recovery. *Accord*, *Bosworth v. Allen*, 168 N.Y. 157, 61 N.E. 163 (1901). *Cf. Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949); *RESTATEMENT, RESTITUTION* § 197, comment c (1937).

²⁹ BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 243 (1932).

³⁰ *Id.* at 220-23. See particularly note 3, where "A.A.B., Jr." makes the observation that the dispute whether the management owes duties solely to the corporation probably can be solved by "closer analysis of the relief asked." He appears to have been concerned, at that moment, solely with problems in which corporate managers profit at the expense of the corporation and makes the point that a corporate recovery normally is necessary to insure that all stockholders will share ratably in the relief. Mr. Berle observes, however, that there are "situations where the directors have harmed the corporation, though there is no apparent loss to the corporation itself." Reference is made, by way of illustration, to the incipient "corporate opportunity" doctrine, hereafter discussed, with the observation that, although it may not be easy in such cases to point out definite damage by depletion of assets, the corporation is deprived of profits which otherwise it might have made. At this point Mr. Berle was not dealing with the specific problem arising from the sale of control shares; nor did he elaborate upon the types of recovery in various situations.

³¹ *Id.* at 244.

³² *Ibid.*

³³ See Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869 (1952), viewing the cases as standing for the proposition that the basis of liability on the sale of control is restricted to negligence or fraud. After *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), the cases were given a closer reading. See Comment, *Shareholders' Liability for Sale of Controlling Interest*, 22 U. CHI. L. REV. 895 (1955). Nevertheless, the rule of liability continued to be phrased in terms of "injury" to the corporation with "knowledge." For a more thoughtful analysis, see Note, *Restrictions on the Transfer of Controlling Stock*, 40 VA. L. REV. 195 (1954). See also Stickells, *Stockholders' Duty in Sale of Stock*, 31 B.U.L. REV. 191 (1951); Note, *Duties of Controlling Shareholders in Transferring Their Shares*, 54 HARV. L. REV. 648 (1941).

tional argument that it abolishes "all profit which inheres in the control of a corporation" and abandons "a basic tenet of free enterprise philosophy."³⁴ It is thought to overlook the "social advantage of a free market for investments"—an advantage which is said to apply equally to transfers of control shares and of shares in the hands of the public.³⁵ Accordingly, it is advocated that the law should place no restraints upon the sale of control shares at a premium over current market prices, except in case of fraud or negligence, resulting in specific injury to the corporation.³⁶

A second argument against the corporate asset theory is seemingly based upon the supposed difficulties in application. It is conceded that a control block possesses two value components: investment value and the appurtenant power of control. But it is asserted that a control block could not possibly be shorn of this appurtenant power.³⁷ Any artificial attempt to separate the control value component from investment value is thought to raise innumerable difficulties of valuation. Nevertheless, in *Perlman v. Feldmann*, the court effectively split the atom into its two value components by shifting the burden of proof on this issue to defendants. This is one of the most significant aspects of the decision.³⁸

³⁴ Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869, 872 (1952). It was also contended that adoption of the Berle theory would "cripple the development of new corporations by sellers of control and the expansion and redevelopment of older corporations by purchasers." This argument proves too much. After all, we do not let Paul rob Peter merely because he may be able to put the stolen property to a better economic use. Moreover, the "cripple industry" argument would apply equally to most of the SEC legislation designed to enforce the accountability of corporate management to shareholders; for example, the restrictions on insider trading under section 16 of the Securities Exchange Act of 1934 and SEC Rule X-10B-5. Surely the vitality of a free economy should not depend upon allowing corporate managers untrammelled rein in this area. Furthermore, as a sweeping generalization of economic behavior, it ignores significant empirical investigations of the economic and tax factors which motivate corporate acquisitions. See generally FTC, *THE PRESENT TREND OF CORPORATE MERGERS AND ACQUISITIONS* 6-23 (1947); FTC, *THE MERGER MOVEMENT, A SUMMARY REPORT* (1948); FTC, *REPORT ON CORPORATE MERGERS AND ACQUISITIONS* 103-42 *passim* (1955); BUTTERS, LINTNER & CARY, *EFFECTS OF TAXATION: CORPORATE MERGERS* 83, 337 (1951); Little, *Why Companies Sell Out*, *Fortune*, Feb. 1956, p. 117.

³⁵ Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869, 872 (1952).

³⁶ See Comment, *Shareholders' Liability for Sale of Controlling Interest*, 22 U. CHI. L. REV. 895 (1955), giving a tortured reading to *Feldmann* in order to buttress this thesis.

³⁷ Judge Swan in his dissent in *Perlman v. Feldmann* states this objection: "The controlling block could not by any possibility be shorn of its appurtenant power to elect directors and through them to control distribution of the corporate product. It is this 'appurtenant power' which gives a controlling block its value as such block. What evidence could be adduced to show the value of the block 'if shorn' of such appurtenant power, I cannot conceive, for it cannot be shorn of it." 219 F.2d at 180.

³⁸ Shifting the burden of proof on this issue to defendants may be justified upon the theory that a controlling shareholder, in effective command of the board of directors, necessarily occupies a fiduciary relation to the corporation where he seeks to derive a personal benefit at the expense of the corporation or other shareholders. The situation is analogous to the burden placed upon the interested director to establish the fairness of his transactions with the corporation. *Kaufman v. Schoenberg*, 91 A.2d 786, 791 (Del. Ch. 1952); BALLANTINE, *CORPORA-*

Finally, it is claimed that the corporate asset theory is without actual support in the cases.³⁹ This argument is somewhat shaken by the decision in *Perlman v. Feldmann*. In that case plaintiffs' basic contention was that "the consideration paid for the stock included compensation for the sale of a corporate asset, a power held in trust for the corporation by Feldmann as its fiduciary." This supposed corporate asset was the "power to allocate the corporate product." Faced with a specific finding that there was no proof of injury or damage to the corporation,⁴⁰ the court apparently recognized that there had been no sale of a corporate asset in any realistic sense. Shifting to the doctrine of corporate "opportunities" which (as we shall see) does not depend upon loss to the corporation,⁴¹ the court stated that Feldmann breached his fiduciary obligation "to the corporation and to the minority stockholders as beneficiaries thereof" by misappropriating a corporate "opportunity" or "advantage," arising from the steel shortage which properly "belonged" to the corporation.⁴²

In the course of establishing this proposition, the court discussed the well known cases of *Young v. Higbee Co.*⁴³ and *Irving Trust Co. v. Deutsch*.⁴⁴ In the *Young* case, Potts and Boag, preferred shareholders, took an appeal from an order confirming a plan of corporate reorganization under Chapter X of the Bankruptcy Act, but subsequently abandoned the

trons § 70 (rev. ed. 1946). A similar fiduciary burden has been imposed upon the controlling shareholder. *Cf. Zahn v. Transamerica Corporation*, 162 F.2d 36 (3d Cir. 1947) (puppet-puppeteer relation between directors and controlling shareholder). See also *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942). Moreover, compare the rule that where a wrongdoer is alone responsible for creating a condition in which damages cannot be measured with precision, he cannot complain that the damages awarded are only an approximation. See *Story Parchment Co. v. Paterson Co.*, 282 U.S. 555, 562 (1931); *Bigelow v. RKO Radio Pictures*, 327 U.S. 251, 265-66 (1946); *Package Closure Corporation v. Sealright Co.*, 141 F.2d 972, 979 (2d Cir. 1944).

³⁹ See note 33 *supra*.

⁴⁰ "There is no evidence of any sort that Newport has suffered from mismanagement or inefficient management . . . , or that it has suffered . . . any harm whatever at the hands of its new management, or that its new management has in any way failed to do anything which should have been done for the good of the corporation." 129 F. Supp. at 176.

⁴¹ For analyses of the corporate opportunity doctrine, see BALLANTINE, CORPORATIONS § 79 (rev. ed. 1946); Comment, *The Doctrine of Corporate Opportunities*, 31 CALIF. L. REV. 188 (1943); Note, *Fiduciary Duty of Officers and Directors Not to Compete with the Corporation*, 54 HARV. L. REV. 1191 (1941).

⁴² The court indicated two gainful opportunities for the corporation: (1) the "Feldmann Plan" might have been used, as in the past, as a means of financing needed plant improvements and additions; (2) the steel shortage might have been utilized to build up patronage in those geographic areas where Newport could compete on profitable terms when the shortage had passed. Plaintiffs were held entitled to recover, even though the "possibility of corporate gain" was by no means a "certainty," and even though failure to exploit these possibilities (when determined as a matter of honest business judgment) would not have given rise to a corporate cause of action.

⁴³ 324 U.S. 204 (1945).

⁴⁴ 73 F.2d 121 (2d Cir. 1934), *cert. denied*, 294 U.S. 708 (1935).

proceedings and sold their stock to their opponents, the junior creditors, for an amount greatly in excess of its market value or the amount to be received by the other preferred shareholders. Even though the transaction was staged as a mere sale of stock, the court was not blind to the fact that Potts and Boag "sold their stock and their appeal" to the junior creditors for a premium. They were held to be in a fiduciary relation not to the corporation, but to the other preferred shareholders and accountable to them for the amount received above the value of the stock. The court stated:⁴⁶

[Potts and Boag] cannot avail themselves of the statutory privilege of litigating for the interest of a class and then shake off their self-assumed responsibilities to others by a simple announcement that henceforth they will trade in the rights of others for their own aggrandizement.

The *Young* decision was clearly correct, but the case does not rest on the corporate asset theory, even if expanded to include corporate opportunities.⁴⁶ Potts and Boag were not corporate managers or officials, acting in a corporate capacity. They were not asserting a corporate cause of action. No corporate asset was "sold" nor was the corporation deprived of any "opportunity" for profit. Potts and Boag were volunteer champions, representing the interests of the preferred shareholders, and only this class of shareholders was injured. Accordingly, they alone shared in the recovery. But the case does stand for the proposition that a court is not to be deceived by the fact that the transaction is cast in the form of a stock sale and emphasizes the desirability of flexibility in working out the form of recovery.

The *Deutsch* case, a leading case on the doctrine of corporate opportunities, was closer to the point. That case held corporate directors accountable for the profits derived from the advantageous purchase of property which in fairness should have been acquired for the corporation, even though there was a possibility that the corporation lacked the necessary funds.⁴⁷ The theory of the corporate "opportunity" cases, which prohibits

⁴⁵ *Young v. Higbee Co.*, 324 U.S. 204, 213 (1945).

⁴⁶ One writer misconceived *Young v. Higbee Co.* to have been a derivative suit. See Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869, 870 (1952). But see Note, *Application of the Rule of Young v. Higbee Co. to Stockholder Derivative Suits*, 13 U. CHI. L. REV. 321 (1946), forecasting the application of the doctrine to derivative suits as was later done in *Clarke v. Greenberg*, 296 N.Y. 146, 71 N.E.2d 443 (1947). In the *Clarke* case, a shareholder, plaintiff in a derivative suit, compromised the action by a "sale" of his stock to the defendants at a price far in excess of its market value. The court held him accountable to the corporation for the excess profits, the theory being that he had sold a corporate asset.

⁴⁷ This evidence of financial inability was largely overcome by countervailing evidence that one of the defendants owed the corporation a substantial sum of money, which, if paid, would have relieved the corporation's financial plight. 73 F.2d at 124. But inability to take advantage of the opportunity may not be a defense. Thus, in *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 202, 80 N.E.2d 522, 530 (1948), a strict court observed: "[T]he argument that a fiduciary is not subject to the general rule here involved [corporate opportunity doctrine] where the venture is one that the corporation itself is unable to take advantage of is not persuasive."

a corporate director or officer from competing with his corporation for business opportunities, does not rest upon the ground of actual injury to the corporation; it stems from a broader policy designed to prevent the fiduciary from utilizing his control position to reap an unfair profit at the expense of the corporation and the shareholders.⁴⁸ The circumstances of the transaction are such that the corporation is the only proper medium for asserting recovery, even though the fiduciary will benefit pro rata to the extent of his share ownership. Yet, the scope of the recovery is not measured by the loss or damage to the corporation, but by gain to the fiduciary.

By shifting from the theory of sale of a corporate asset to that of seizure of a corporate opportunity, the court in the *Feldmann* case disposed of the logical consequence that recovery depended upon actual injury to the corporation. But the court did not thereby eliminate the implication that any recovery should go directly to the corporation. Whether the corporation had lost an asset or opportunity to profit, surely it should have had the entire recovery. But the court significantly awarded relief to the individual plaintiffs. This disposition raises the issue whether the court really bottomed the case on the corporate opportunity theory or whether some broader, not fully articulated, principle came into play. *Irving Trust Co. v. Deutsch*, which was relied upon by the court in the *Feldmann* case, rested on the corporate opportunity doctrine and, accordingly, resulted in a corporate recovery. But the basis for the view that in the *Feldmann* case the corporation lost a business opportunity or was deprived of a profit is somewhat tenuous. *Young v. Higbee Co.*, on the other hand, which was likewise invoked by the court, gave an individual recovery but depended on the breach of fiduciary obligation directly to the plaintiffs. The answer to this dilemma which confronted the court in reaching its ultimate result necessitates a more detailed analysis of the factors which enter into the marketability of control.⁴⁹

⁴⁸ As the court put it in *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939), "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders The standard of loyalty is measured by no fixed scale. If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. *The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.*" (Emphasis added.) *Accord*, *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522 (1948); *Greene v. Allen*, 114 A.2d 916 (Del. Ch. 1955) (president and director may not usurp a corporate opportunity even though discovered by him in his individual capacity and acquired only after rejection by a dominated board of directors).

⁴⁹ Judge Swan, in his dissenting opinion, recognized that the majority, by adopting the corporate opportunity doctrine, was faced with a dilemma. After emphasizing that there was

III

MARKETABILITY OF CORPORATE CONTROL: ITS ELEMENTS AND ANATOMY

As share ownership becomes more widely diffused, control of the corporation tends to be concentrated in a self-perpetuating board of directors. Except for some of the giant corporations, however, control is likely to be localized in a majority shareholder or in a cohesive group who possess the power to elect a board of directors through stock ownership.⁵⁰ This strategic position permits the exertion of influence on management in many ways.⁵¹ It may be utilized positively to organize an energetic and capable managerial echelon, improve earnings, and thereby boost the price of the stock, to the benefit of all stockholders. The management team, which provides the life blood of the 20th century corporate system, can be rewarded by various forms of compensation designed to provide the corporate executive with an adequate living wage.⁵² On the other hand, control may be exploited for personal advantage in a variety of ways, at the expense of the outside shareholders.

A.

*Exploitation of Corporate "Patronage"⁵³
or Other Non-Balance-Sheet Assets*

The emoluments of control may take many forms. Thus, more or less important jobs may be dispensed to relatives and friends irrespective of

no proof that Newport suffered any detriment from the transaction, he fired this closing shot: "If a corporate asset was sold, surely the corporation should recover the compensation received for it by the defendants. Moreover, if the plaintiffs are suing in their own right, Newport was not a proper party." 219 F.2d at 180.

⁵⁰ This generalization seems sufficiently accurate for present purposes. See BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); BURNHAM, *THE MANAGERIAL REVOLUTION* (1941). For a more recent survey, see Papandreou, *Some Basic Problems in the Theory of the Firm*, and comments, in 2 *A SURVEY OF CONTEMPORARY ECONOMICS* 183 (Haley ed. 1952). For an extensive bibliography of relevant literature, see report of the Committee on Business Enterprise Research of the Social Science Research Council, BOWEN, *THE BUSINESS ENTERPRISE AS A SUBJECT FOR RESEARCH* (Soc. Sci. Research Council Pamphlet No. 11, 1955) (listing over 400 titles).

⁵¹ Financial writers divide control into three types: (1) "absolute control" which exists where a person or group own a majority of the voting stock; (2) "working control," which may be achieved even without majority control, if the shares are widely scattered, by the concentration of as little as 10% of the outstanding stock; (3) "open market control" which is present where the holdings of the "insiders" are so small that an outside group may make a creeping acquisition of control by the steady purchase of shares, with or without a proxy fight. See Graham, *Controlling Versus Outside Stockholders*, 4 *V.A. L. WEEKLY, DICTA COMP.* 111 (1953); cf. DIMOCK & HYDE, *BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS* 19-22 (TNEC Monograph No. 11, 1940). Neither a creeping acquisition nor a "raid" is to be confused with a negotiated purchase of control shares such as occurred in *Pertman v. Feldmann*. See Saunders, *How Managements Get Tipped Over*, *Fortune*, Oct. 1955, p. 123.

⁵² See generally, WASHINGTON AND ROTHSCHILD, *COMPENSATING THE CORPORATE EXECUTIVE* (rev. ed. 1951); Wasbington, *The Corporation Executive's Living Wage*, 54 *HARV. L. REV.* 733 (1941).

⁵³ See generally SEC, *REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES,*

merit or qualifications, to the extent that they are not reserved for the controlling shareholders.⁵⁴ Fees may be paid for management contracts and services;⁵⁵ and contracts for the purchase and sale of goods and services may be diverted to the interested persons and firms.⁵⁶ The opportunity to sell to the corporation in a period of abundance and to purchase from it in a period of market shortage can be of incalculable value to a control group.

Generally speaking, in this situation, the courts have reacted vigorously when the controlling interests have sought to collect a toll on goods moving into,⁵⁷ or out of,⁵⁸ the corporation and have impressed the profits with a trust for the corporation. In this area there is a growing tendency for the courts to protect the less powerful outside shareholders from overreaching by the more powerful controlling interests.⁵⁹

Quite apart from day-to-day operations, the corporation may possess valuable "assets" which do not even appear on the balance sheet. It may, for example, have a net operating loss deduction which an acquiring corporation can carry over as a tax credit against future earnings. Loss cor-

PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. I, at 136-218 *passim* (1937) (still the basic empirical investigation); SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES pt. III, at 1020-23, 1092-1237, *passim* (1940); Hornstein, *Corporate Control and Private Property Rules*, 92 U. PA. L. REV. 1, 4 (1943); Gilbert, *McPhail—The Nadir in Proxy Fights*, 18 U. DET. L.J. 7, 9-11 (1954). See also dissenting opinion of Judge Van Voorhis comparing corporate and political "patronage," *Rosenfeld v. Fairchild Engine and Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955).

⁵⁴ See, e.g., *Foll's Appeal*, 91 Pa. 434 (1879), where an equity court denied specific performance of a contract to purchase shares of a bank, because the objective was to corner control and take over the positions of cashier and director. A recent statistical study of 23,000 major American corporations revealed a threat of nepotism in 51% of these companies. *Nepotism, The Corporate Director* (Am. Inst. of Managm't, Oct. 1955). See also SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. II, at 78-91 (1937) (case study of Paramount-Publix Corporation prior to its reorganization in 1933-1935); Gilbert, *McPhail—The Nadir in Proxy Fights*, 18 U. DET. L.J. 7, 9 (1954).

⁵⁵ *Mayflower Hotel Stock. P. Com. v. Mayflower Hotel Corp.*, 193 F.2d 666 (D.C. Cir. 1951); *Cullen v. Governor Clinton Co.*, 279 App. Div. 483, 110 N.Y.S.2d 614 (1952); *Kennerston v. Burbank Amusement Co.*, 120 Cal. App.2d 157, 260 P.2d 823 (1953); DIMOCK & HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS 111 (TNEC Monograph No. 11, 1940); SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES pt. III, c. 4, p. 1086 n (1940).

⁵⁶ *Price v. Standard Oil Co.*, 55 N.Y.S.2d 890 (Sup. Ct. 1945) (sales); *Bliss Petroleum Co. v. McNally*, 254 Mich. 569, 237 N.W. 53 (1931) (purchase).

⁵⁷ *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522 (1948) (toll taken through "corporate middleman" controlled by interested director); *cf. Findley v. Garrett*, 109 Cal. App.2d 166, 240 P.2d 421 (1952) (but refusal of independent majority of directors to sue bars a derivative suit).

⁵⁸ *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App.2d 405, 241 P.2d 66 (1952) (toll taken through sales corporation owned by controlling shareholders-directors).

⁵⁹ For a striking example, see *Greene v. Allen*, 114 A.2d 916 (Del. Ch. 1955).

porations constitute, in fact, a marketable asset in the form of various tax benefits which may be extremely valuable to transferees of control.⁶⁰ These examples will suffice to illustrate some of the emoluments of control which clearly do not represent corporate assets in the conventional sense. On the contrary, they represent opportunities for use of the control position for personal profit at the expense of the outside shareholders. It is precisely these opportunities for profit, not available to the minority, which ordinarily give the control stock its increased value.⁶¹

B.

*Exploitation of Power to Intercept or Divert Profits in Connection with Corporate Reorganizations and Liquidations*⁶²

A recent study of the motivations behind the current merger movement states:⁶³

The reason that industrial purchasers sometimes are willing to pay a relatively high price for controlling interests is that they are mainly interested in the assets (broadly defined) of the acquired company.

Whether a majority shareholder or group may exploit their strategic position by selling control over the underlying assets to outside interests depends, in part, upon the legal form in which the transaction is cast. There are several avenues for the transfer of such control. Among these are sale of all assets, mergers and stock acquisitions. Thus the transferee may acquire all of the corporate assets, paying in cash or stock, after which the

⁶⁰ See Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right is Doing?*, 103 U. PA. L. REV. 579, 589 (1955); Cohen, Phillips, Surrey, Tarleau, and Warren, *The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax*, 10 TAX L. REV. 277, 281 (1955); Arent, *Tax Aspects of Buying Loss Corporations Under the 1954 Code*, 33 TAXES 955 (1955), where the author states: "Despite the sustained efforts of the Treasury Department and the Congress to prevent the use of loss corporations for tax avoidance, corporations with large operating loss carry-overs continue to be sold at a premium." Barnard, *Acquisitions for Tax Benefit*, 34 CALIF. L. REV. 36 (1946); Rudick, *Acquisitions to Avoid Income or Excess Profits Tax*, 58 HARV. L. REV. 196 (1944). See also FTC, REPORT ON CORPORATE MERGERS AND ACQUISITIONS 11, 99, 137 (1955) (tax motivations, including account of acquisition of Willys-Overland Motors, Inc. by a subsidiary of Kaiser-Fraser Corp.); cf. *Western Pac. R. Corporation v. Western Pac. R. Co.*, 85 F. Supp. 868 (N.D. Cal. 1949); *aff'd*, 197 F.2d 994 (9th Cir. 1951), 38 CALIF. L. REV. 946 (1950), 65 HARV. L. REV. 1256 (1952).

⁶¹ We are here concerned with existing control as a salable commodity. Short of having "majority" or "absolute" control, the free shares may also have a value to those who wish to effect control. For example, suppose X corporation has outstanding 100 shares, of which A owns 49, B owns 49, and C owns 2 shares. If A and B constitute separate blocs, C's shares have a special value for the purpose of achieving control. But C's shares, in his hands, do not possess control unless they are united with one of the blocs.

⁶² Readers familiar with the Dodd and Baker *Corporations* casebook will recognize the writer's debt to the editors for their "Note on Problem of Equal Opportunity, Price or Realization." DODD AND BAKER, CASES AND MATERIALS ON CORPORATIONS 570-79 (2d ed. 1951).

⁶³ BUTTERS, LINTNER & CARY, EFFECTS OF TAXATION: CORPORATE MERGERS 83 (1951).

selling corporation may be liquidated and the net assets distributed to the shareholders. As a practical matter, the deal can be consummated only after a bargain has been struck between the purchaser and the control group and the latter has been induced to approve the sale of assets. Nevertheless, the transaction will result in the equal treatment of all shareholders, unless some side payment is made to the controlling group. The courts have in general successfully frustrated the side-payment technique of capitalizing on control, so that in this situation the principle of equality of treatment is well-established.⁶⁴

If control is achieved through a merger or consolidation, the dominant shareholders must similarly be induced to approve the transaction and the terms of the proposed merger. But again, the members of the group will derive no special advantage by virtue of their stock ownership, since all shareholders in the acquired corporation will receive shares in the surviving corporation on a pro rata basis.

According to studies of the Federal Trade Commission, the most widely used method of financing a corporate acquisition is that of interchanging shares of the acquiring corporation with shares of the acquired company.⁶⁵ The normal procedure is first to arrive at a basis acceptable to the control group.⁶⁶ An offer is then made to all shareholders, generally made conditional on the exchange of a stated percentage of shares of the acquired company.⁶⁷ Where a general offer is made to all shareholders, the result is the same as in transfers of assets and mergers, there being no opportunity for the controlling shareholders to cash in on their position.

⁶⁴ See, e.g., *American T. Co. v. California etc. Ins. Co.*, 15 Cal.2d 42, 98 P.2d 497 (1940) (control group induced outside shareholders to accept general offer to exchange shares without disclosing secret agreement by acquiring company to repurchase part of the shares from the control group at 50% above the market price); Note, 29 CALIF. L. REV. 67 (1940). *But cf.* *Gallagher v. Pacific American Co.*, 97 F.2d 193 (9th Cir. 1938) (a questionable decision).

⁶⁵ FTC, REPORT ON CORPORATE MERGERS AND ACQUISITIONS 9 (1955).

⁶⁶ If the management of the company to be acquired owns or controls substantial stock, they are not likely to be by-passed, because of the grave danger that the purchaser may become locked into a minority position. "Control" must be bought from them! In a case of "open market control" a weak management may be by-passed. Thus, in 1954, F. H. Peavey & Co. took the management completely by surprise with a conditional general offer to shareholders of Russell-Miller Milling Co. and successfully acquired 90% of the common stock. See FTC, REPORT ON CORPORATE MERGERS AND ACQUISITIONS 86 (1955). For a stimulating discussion of the English practice, see Gower, *Corporate Control: The Battle for the Berkeley*, 68 HARV. L. REV. 1176, 1178, 1182 (1955).

⁶⁷ *Ibid.* See note 12 *supra*; *Mayflower Hotel Stock. P. Com. v. Mayflower Hotel Corp.*, 193 F.2d 666 (D.C. Cir. 1951). Conditional offers serve at least three purposes: (1) to assure that sufficient stock will be acquired to give "control"; (2) to secure at least 80% of the voting power and thus qualify as a tax free reorganization under section 368(c) of the INT. REV. CODE OF 1954; (3) to permit the filing of consolidated returns as affiliated corporations. INT. REV. CODE OF 1954 § 1504. See Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 416 (1955).

On the other hand, the dominant group may insist on a private sale of their shares for cash or property at a price not generally available to other shareholders.⁶⁸ They may thus attempt to trade in control, by obtaining a premium for the leverage value of the shares.

In order to sharpen the problem for the purpose of analysis, let us assume that Smart is the president, a director, and owner of 51% of the shares of A Mining Corporation. The corporation is presently inactive and, according to its balance sheet, is barely solvent, but it has a net operating loss tax credit arising from prior losses. The remaining shares are widely held and have no market value. B Corporation approaches Smart with a view to effecting a merger with A Corporation and thereby getting the benefit of the tax deduction which B Corporation values at \$200,000. Smart knows that he cannot realize a special premium on the sale of his control block if the transaction is handled either as a merger or as a sale of assets for stock. Since Smart's stock is essential to any merger, B Corporation agrees to purchase his stock for \$150,000. The purchase is made conditional upon Smart procuring resignations of the existing directors and the substitution of a new board to be selected by the purchaser. This procedure operates to insure that the directorate of A Corporation will take the steps needed to consummate the merger and facilitate the transfer of control. For a slight additional expenditure, B Corporation is able to purchase enough other shares in the open market to effectuate the merger. A Corporation is merged into B Corporation so that A loses its identity and presumably any causes of action which it may have. Minority shareholders of A Corporation are forced to elect between accepting shares of B Corporation in an amount equal to the investment value of their shares in A Corporation or asserting their rights of appraisal. Under either choice these

⁶⁸ What available data exist seem to indicate that the private sale of control shares at a premium is no longer the "customary" practice, despite Judge Swan's suggestion to the contrary in *Perlman v. Feldmann*. See FTC, REPORT ON CORPORATE MERGERS AND ACQUISITION 85-88 (1955); BUTTERS, LINTNER & CARY, EFFECTS OF TAXATION: CORPORATE MERGERS 83, 337 (1951).

Moreover, there is mounting evidence that the business community and many corporation lawyers regard it as a "sharp" practice, of which they will have no part. Thus Vanderpoel, Financial Writer of the *Chicago Sun-Times*, has written: "[T]here is a unanimous conviction on the part of those who have taken special interest in small stockholders that it is unethical for a management group to sell control of a company to outside interests on terms not made available to all stockholders." Quoted in Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869 (1952). Likewise, GRAHAM AND DOOD, SECURITY ANALYSIS 736, Appendix Note 51 (3d ed. 1951) report that in June 1947, a poll of 573 members of the New York Society of Security Analysts showed that seven out of eight believed "it is the duty of the management to transmit to stockholders any offer to purchase a substantial number of shares at more than the current market price . . ." A partner in one of the nation's leading investment banking firms, who requests anonymity, has told the writer: "We won't handle such deals. It isn't right. All must sell at the same price and must receive the same information."

minority shares are of little value. Some shareholders accept the shares of B Corporation, others assert their rights of appraisal. What remedies are available to each class against Smart? And what about the shareholders who sold their shares to B Corporation? May they recover their pro rata share of the purchase price from Smart? The answers to these questions obviously are intimately bound up with the theories of recovery and the remedies available.

IV

APPROPRIATE BASES OF RECOVERY UNDER THE EMERGING LAW

There are a number of angles from which the courts have approached the problem of trading in corporate control.

A.

Theory of Sale of Office

This theory has a double aspect. Where the management and control is turned over to strangers, the corporation or outside shareholders may seek to recover payments or bonuses received for such transfer on the theory either: (1) that payment was made for loss of office; or (2) that the office was "sold."

The former approach was taken in the case of *Gaskell v. Chambers*,⁶⁹ which established the principle in English law that, upon the sale of assets and business of a company, the directors cannot keep amounts paid by the purchaser as compensation for the loss of offices, unless full disclosure is made to the shareholders and their approval is obtained. The decision rejected the contentions of defendant-directors: (1) that plaintiff-shareholder must have known of the well-recognized custom on a corporate acquisition to compensate the directors who lose their offices as a consequence of the transaction; and (2) that neither the selling corporation nor its shareholders were injured, because the compensation was paid by the acquiring company. Since the selling corporation had been liquidated and reduced to a merely formal existence, a shareholder was allowed to bring a direct action to impress a trust upon the proceeds for the benefit of all shareholders.

The *Gaskell* rule is now codified in section 192 of the English Companies Act of 1948,⁷⁰ which provides that where all or part of a company's undertaking or property are transferred, any amounts paid to the directors as compensation for loss of or retirement from office are held in trust for the company, unless full disclosure thereof is made to the members and the company approves. Section 193 enacts a somewhat parallel rule with re-

⁶⁹ 26 Beav. 360, 53 Eng. Rep. 937 (1858).

⁷⁰ 11 & 12 Geo. VI, c. 38, § 192.

spect to transfers of control by means of stock acquisitions, where a general offer is made to all or part of the shareholders. If, in such cases, a payment is to be made to a director as compensation for loss of or retirement from office, full particulars must be furnished to the shareholders as a part of the general offer. Unless approved by a general meeting of the shareholders of the classes affected (voting by classes) any amounts so received by a director are impressed with a trust solely for those shareholders who sold shares pursuant to the offer.⁷¹ Thus, irrespective of the procedures used to transfer control, whether through sale of assets or stock acquisition by means of a general offer to shareholders, in England company directors must disgorge secret payments for loss of office. There is, however, no authoritative English ruling as to the legal effect when the same objective is sought to be achieved by means of a negotiated purchase of shares, not accompanied by a general offer to all or part of the shareholders.

In the United States, the courts have developed an analogous rule under the theory of sale of corporate office. It is, of course, the general rule that a director, like a trustee, can ordinarily resign his agency at any time as long as he does not leave the interests of the corporation without proper care and protection.⁷² But the director is not permitted to derive a personal profit or advantage from agreeing to resign, and such agreements are held unenforceable as being contrary to public policy.⁷³

A more difficult problem has to be met when a controlling block of stock is sold to outside interests, and the seller agrees to procure resignations of the board of directors and substitute the nominees of the purchasers. In several cases litigation has arisen between the seller and purchaser and the claim has been made that a contract to transfer control and management of a corporation, without consent of the minority shareholders, is unen-

⁷¹ The section in terms is not applicable to negotiated purchases, where no general offer is made. See GOWER, *MODERN COMPANY LAW* 138, 533 (1954); BUCKLEY (LORD WRENBURY), *THE COMPANIES ACT* 388 (12th ed. 1949); 6 HALSBURY, *THE LAWS OF ENGLAND* 304 (3d ed. 1954). The commentators do not explain why all outside shareholders are not allowed to share in the proceeds.

⁷² 1 MORAWETZ, *CORPORATIONS* § 563 (2d ed. 1886); BALLANTINE, *CORPORATIONS* 218 (rev. ed. 1946). This is undoubtedly the legal foundation for recovery against the transferor of control in the looting cases. *Insuranshares Corporation v. Northern Fiscal Corp.*, 35 F.Supp. 22 (E.D. Pa. 1940); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941), *referee's report confirmed*, 30 N.Y.S.2d 755 (1941); *Dale v. Temple Co.*, 186 Tenn. 69, 208 S.W.2d 344 (1948). Cf. *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1st Dep't 1942). On the other hand, the looter may be proceeded against either in tort or, in the event of bankruptcy, under § 70(e) of the Bankruptcy Act, 11 U.S.C.A. § 110(e) (1953), on the theory of fraudulent conveyance. See *Eisenrod v. Utley*, 211 F.2d 678 (9th Cir. 1954).

⁷³ *Forbes v. McDonald*, 54 Cal. 98 (1880).

forceable as against public policy.⁷⁴ In *Barnes v. Brown*⁷⁵ an action for fraud was brought by the seller of a majority of the shares for failure of the purchasers to make the stipulated payment. The purchasers defended the action on the ground that the promise to procure resignations and substitute the purchasers' nominees as directors rendered the entire agreement illegal. The court sustained this provision of the contract, noting, however, that the purchasers were seeking to avoid liability for fraud by claiming illegality after having obtained all the benefits of the bargain, and that there was no proof of harm to the corporation or of objections voiced at any time by outside shareholders.

In sharp contrast were the cases where the corporation or minority shareholders conjured up the specter of sale of corporate office. This doctrine emerged in *McClure v. Law*,⁷⁶ where a receiver of an insolvent insurance company recovered payments secured by defendant, a former president and director, for delivering control of a corporation to a stranger. Without purporting to sell any shares, the transfer was accomplished by procuring resignations of the directors and substituting a new board, which promptly looted the corporation. The basis of the complaint was not injury or damage to the corporation, but breach of fiduciary obligation. The court, accepting the theory, stated:⁷⁷

As president and director of the [corporation, the defendant] was bound to account to that association for all moneys that came into his hands by virtue of his official acts The election of directors and the transfer of the management and property of the corporation were official acts, and whatever money he received from such official acts were moneys derived by virtue of his office for which we think he should account.

The same doctrine was followed not long thereafter where the transfer of control was accomplished through the sale of stock. In *Bosworth v. Allen*,⁷⁸ another case of looting, the complaint by the receiver against the

⁷⁴ A few courts have denied specific performance of contracts to sell controlling shares on the ground that, although not illegal, equity should refuse enforcement. *Fremont v. Stone*, 42 Barb. 169 (N.Y. Sup. Ct. 1864); *Rimes v. Rimes*, 152 Ga. 721, 111 S.E. 34 (1922); *Clowes v. Miller*, 74 Conn. 287, 50 Atl. 728 (1901). *Cf. Foll's Appeal*, 91 Pa. 434 (1879) (quasi-public institution). *Contra*, *Northern Central Ry. Co. v. Walworth*, 193 Pa. 207, 44 Atl. 253 (1899); *Sherwood v. Wallin*, 1 Cal. App. 532, 82 Pac. 566 (1905).

⁷⁵ 80 N.Y. 527 (1880). See also *San Remo Copper Mining Co. v. Moneuse*, 149 App. Div. 26, 133 N.Y. Supp. 509 (1912). *But see* *Fremont v. Stone*, 42 Barb. 169 (N.Y. Sup. Ct. 1864). *Cf. Roosevelt v. Hamblin*, 199 Mass. 127, 133, 85 N.E. 98, 101 (1908) (incorporators who refused to subscribe to shares had no further interest in corporation and no standing to complain); *Farmers' L. & T. Co. v. N.Y. & N. R. Co.*, 150 N.Y. 410, 44 N.E. 1043 (1896); *Wood v. Manchester Fire Ins. Co.*, 30 Misc. 330, 63 N.Y. Supp. 427 (Sup. Ct. 1900).

⁷⁶ 161 N.Y. 78, 55 N.E. 388 (1899). See also *Moulton v. Field*, 166 Fed. 607 (N.D. Ill. 1908), *aff'd*, 179 Fed. 673 (7th Cir. 1910), *cert. denied*, 219 U.S. 586 (1911).

⁷⁷ 161 N.Y. 78, 81, 55 N.E. 388, 389 (1899).

⁷⁸ 168 N.Y. 157, 61 N.E. 163 (1901).

former directors of a savings and loan association charged a conspiracy and proceeded on two theories: (1) that defendants had sold their shares to the purchasers for an amount far in excess of the withdrawal value of the shares and that this excess was paid for their resignations; and (2) that defendants had committed a tort in transferring control to persons whom they knew to be irresponsible. Recovery was sought on both grounds. The court, in reversing an order sustaining a demurrer on the ground of improper joinder of causes of action, held that through a single action for accounting, relief could be given on both bases:⁷⁹

If [directors] are treacherous to [the corporation's] . . . interests and appropriate its property, or intentionally waste its assets, or take money for official action, or "sell out" by resigning and thus giving control to others, they are liable to account in equity to the corporation or its representatives, not only for the money or property in their hands, but also for such as they fraudulently disposed of or wasted, as well as for the damages naturally resulting from their official misconduct, and even, as we have recently held, for money received by virtue of their office. (*McClure v. Law*, 161 N.Y. 78).

Thus, even though the transaction was staged as a mere sale of a control block of stock, the court had no difficulty in separating the compensation for the appurtenant power of control from the investment value of the shares, because the shares in the corporation—a savings and loan association—had a fixed withdrawal value. The case, therefore, was not essentially different from the *McClure* case which involved a bare-faced sale of corporate control per se.

McClure v. Law and *Bosworth v. Allen* nevertheless formed the controlling precedent for *Gerdes v. Reynolds*, previously referred to,⁸⁰ where the ascertainment of the control component was not so patent. In that case, the court granted recovery for injury caused by looting and for the excess profit obtained on the sale of the control shares. The court was not embarrassed by the fact that the premium was not readily ascertainable; it was satisfied that in view of all surrounding circumstances it could arrive at a plausible result.⁸¹

B.

Corporate Transaction Theory

This approach was developed in the instance where the controlling group sought to intercept profits in connection with a corporate transaction, such as the sale of corporate assets. In *Commonwealth T. I. & Tr. Co. v. Seltzer*⁸² defendant-directors, when approached by the agent for

⁷⁹ 168 N.Y. at 166, 61 N.E. at 165.

⁸⁰ 28 N.Y.S.2d 622 (Sup. Ct. 1941). See note 28 *supra*.

⁸¹ *Id.* at 658.

⁸² 227 Pa. 410, 76 Atl. 77 (1910).

another corporation desiring to purchase their corporation's assets, did not disclose the offer to the other shareholders, but stated that the property could not be bought, although they knew that the corporation was willing to sell. Instead, the defendants negotiated with the agent a contract whereby the latter was granted an option to purchase from the defendant a number of shares sufficient to control the corporation. Since the defendants did not own enough stock themselves, they purchased the additional stock needed from outside shareholders and carried out the scheme. Defendants did not resign their directorships, but participated in the corporate proceedings by which the assets were sold to the purchasing corporation at a price which the court found not to be inadequate. Plaintiffs, shareholders, sought to impress a trust upon the excess profits intercepted by defendants. The court held that the special profit received on the sale of the controlling stock was, in substance, a profit derived from the sale of corporate property. The court was not deceived by the attempt to give the appearance of separate transactions to a single plan to effectuate the transfer of corporate assets through the sale of the controlling block of stock. The court thus stated the theory of the relief:⁸³

These defendants as managing officers were under an inherent obligation not to in any manner use their positions to advance their individual interests as distinguished from the interests of their corporation The purchaser wanted the property and was willing to pay a price for it. The defendants knew this, and the facts justify the inference that the stock dealing was for the very purpose of diverting a part of that price from the corporation into their own pockets; and this, in a nutshell, is the theory upon which the case was decided [in the trial court].

Although the proceeding was in form derivative, since the corporation had distributed most of its assets and apparently had only a formal existence, the court gave a personal recovery rather than indulging in the more expensive remedy of appointing a receiver.⁸⁴

The *Seltzer* case foreshadowed the decision in *Feldmann*, both as to remedy and result, but since in the latter case the purchaser only wanted to acquire the stock so as to obtain control of the corporate output rather than of its assets, the ultimate boundaries of the corporate transaction doctrine become a proper subject for speculation.

*Tryon v. Smith*⁸⁵ is a good case to test the scope of the theory. Smith, the defendant, was the former president and director of a banking cor-

⁸³ *Id.* at 416-18, 76 Atl. at 79.

⁸⁴ Since defendants had paid more for some of the stock than they received on the resale, the plaintiffs were awarded merely their proportionate share of the net profits on these transactions. As a result the plaintiffs received the same share which they would have received had these profits gone into the corporate treasury instead of into defendants' pockets.

⁸⁵ 191 Ore. 172, 229 P.2d 251 (1951).

poration of which he, his family, and other bank directors altogether owned 70 per cent of the stock. Smith received an offer from Transamerica Corporation, the bank holding company,⁸⁶ to purchase all of the stock at the book value (\$200 per share), plus \$500,000. Defendant did not communicate this offer to the outside shareholders, but rejected it, stating that he would deal only with respect to his own stock and that of his family. He indicated that although Transamerica would have to deal directly with the outside shareholders, he wanted the minority to have the privilege of selling their shares and that they were entitled to more than book value and should have at least \$220 per share. Transamerica paid the minority shareholders \$220 per share, and when all the outside stock had been acquired, paid defendant, his family, and his associates \$460 per share for their stock.⁸⁷ The complaint was by some of the former minority shareholders to recover damages for fraud, the theory being that defendant had breached a fiduciary duty to them by concealing from them knowledge that he and his associates were receiving \$460 for their shares prior to the sale by the minority of its stock for \$220 per share. The court, in denying recovery, stated:⁸⁸

There being no fiduciary relationship existing between the stockholders of the bank so far as the sale of individual stock was concerned, there was no duty upon the part of Smith to apprise minority stockholders of Transamerica's offer. The fact that Smith et al. received more for their stock than the minority is not evidence of fraud, since it is generally recognized that the stock of majority stockholders is of more value than that of the minority.⁸⁹

⁸⁶ See JAMES AND JAMES, BIOGRAPHY OF A BANK—THE STORY OF BANK OF AMERICA N.T. & S.A. 291 *passim* (1954).

⁸⁷ Although it cannot be clearly ascertained, it appears probable that defendant and his associates were committed prior to Transamerica's acquisition of the minority shares. It was not Transamerica's habit to acquire minority interests in banks and thereby run the risk of becoming locked into a minority position. Of the 48 banks in which Transamerica had an interest, following this acquisition, it had a majority interest in all except two banks—Bank of America N.T. & S.A. (22.48 per cent) and the Citizens National Bank of Los Angeles (23 per cent). *Id.* at 501. If Smith were not so committed, and if he had no duty to communicate the general offer to shareholders, the case presents no problems. After the minority interests sold out the Smith group owned 70% and Transamerica owned 30%. Obviously, the Smith group could then sell the control shares to Transamerica at what the traffic would bear.

⁸⁸ 191 Ore. at 180, 229 P.2d at 254.

⁸⁹ This philosophy gives the dominant stockholder vast powers to discriminate between shareholders. It is not clear whether Smith and his family owned an absolute majority of the shares. Apparently he later expanded the group to include other bank directors. He might have shared the "control fund" with additional shareholders.

Where a fiduciary intercepts or diverts profits, he is personally liable, though the profits are channeled to a third person. If the latter knowingly joins a fiduciary in breaching his obligation, he becomes jointly and severally liable with the fiduciary to the extent of his profits. *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 196, 80 N.E.2d 522, 527 (1948); *Irving Trust Co. v. Deutsch*, 73 F.2d 121, 125 (2d Cir. 1934); *McClure v. Wilson*, 70 App. Div. 149, 75 N.Y.

The crucial question, of course, is whether defendant, the president and dominant shareholder of the corporation, receiving a general offer to purchase all the shares, could treat the offer as having been received in his individual capacity and reject it out of hand, or whether he had a fiduciary obligation to transmit the offer to the outside shareholders and advise them of his rejection.⁹⁰

The result in *Tryon* appears dubious unless a distinction is to be drawn between the situation where the purchaser desires to acquire the assets of the corporation and where he desires to acquire all the stock (as in *Tryon*) or a controlling stock interest (as in *Feldmann*) with a view to controlling the underlying assets. Further, even if the court had been willing to frown on defendant's course of action, the corporate asset theory would not have furnished an appropriate basis for a recovery and again would have revealed itself as only a half-truth. Only the selling shareholders had been injured; they, however, would not have benefited by a corporate recovery even if the court had accorded them standing to maintain the action. But as Judge Peters recently stated:⁹¹

It is hornbook law that directors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit. The concept that a corporation is an entity cannot operate so as to lessen the duties owed to all of the stockholders.

Accordingly, the possibility cannot be entirely dismissed that in a proper case a court will respond to the radiations of light cast by *Seltzer* and *Feldmann* and give the selling shareholders a direct cause of action in this situation.

But if this be so, suppose that in the *Tryon* situation some of the minority shareholders had hung on and refused to sell their shares? A court might then face the problem whether it should grant them a direct cause of action, or permit them a derivative action with a personal recovery (as

Supp. 212 (1st Dep't 1902); *Finch v. Warrior Cement Corp.*, 16 Del. Ch. 44, 61, 141 Atl. 54, 62 (1928). Cf. *Jackson v. Smith*, 254 U.S. 586, 588 (1921) (court appointed receiver); RESTATEMENT, RESTITUTION § 201(2) (1937); Note, *Application of SEC Rule X-10B-5 to Prevent Nondisclosure in the Sale of Corporate Securities*, 39 CALIF. L. REV. 429, 437 (1951) (discussing application of fiduciary rule to members of family, business associates, and nonbusiness associates). This fiduciary rule provides the basis for the judgment in the *Feldmann* case against his relatives and business associates.

⁹⁰ Cf. *Greene v. Allen*, 114 A.2d 916 (Del. Ch. 1955).

⁹¹ *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App.2d 405, 419, 241 P.2d 66, 74 (1952). Cf. *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 487, 488 (1919); *Pepper v. Litton*, 308 U.S. 295, 306-07, 311 (1939); *Lebold v. Inland Steel Co.*, 125 F.2d 369, 373 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942); *Zahn v. Transamerica Corporation*, 162 F.2d 36 (3d Cir. 1947).

in *Feldmann*), or exclude them from participation in the recovery, thus approximating the form of redress prescribed in section 193 of the English Companies Act of 1948, in which only the selling shareholders participate.⁹²

*Porter v. Healy*⁹³ offers a possible guidepost for the solution of this problem. Defendants were officers and directors of A Corporation, which had outstanding 700 shares of which defendants owned or controlled 383 shares. B Corporation was willing to pay \$202,330 for all of the stock. A bargain was struck with defendants under which B Corporation set aside \$115,500 to be applied toward the purchase of all 700 shares at \$165 per share, and the further sum of \$86,830 was deposited as a separate fund. B Corporation then made a general offer to shareholders advising them that the majority stockholders had sold their holdings at \$165 per share upon the understanding that all other shareholders should have the same privilege and that \$115,500 was on deposit to take up the stock. In fact, under a secret arrangement, at the closing the defendants tendered their resignations, substituted B Corporation's nominees as directors and officers, and received the additional "control fund" of \$86,830. This "bonus" was not distributed among the defendants according to stock ownership, thus in part negating their later contention that they had merely sold their stock. All of the outside shareholders save two of the plaintiffs accepted the general offer and sold at \$165 per share. A Corporation then merged into B Corporation. The two shareholders who hung on to their stock finally succumbed too and also accepted \$165 per share, the price offered by those in charge of the merger.

The complaint sought a discovery and an accounting from the defendants for the profits derived through receipt of the "control fund." The plaintiffs consisted of shareholders who had sold shares as a result of the general offer and of the two shareholders who had later accepted the price offered at the time of merger. In spite of the fact that all shareholders had parted with their stock prior to instituting suit, and thus were barred from bringing or benefiting by a derivative suit, the court permitted plaintiffs to maintain actions in their own right and allowed each to recover a share of the bonus of \$86,830 proportionate to his respective stock interest.⁹⁴

⁹² See text at note 71 *supra*.

⁹³ 244 Pa. 427, 91 Atl. 428 (1914).

⁹⁴ The court quoted with approval the chancellor's theory permitting individual suits: "If directors are guilty of a breach of trust, injuries . . . to the rights of the shareholders, or a portion of them may be redressed at the suit of the injured stockholders; the rule is founded in part upon the consideration, that directors are trustees for the stockholders, and that in any action to redress breaches of trust on the part of directors toward stockholders, the shareholders are the real parties in interest' . . . [citing *Commonwealth T. I. & Tr. Co. v. Seltzer*, 227 Pa. 410, 76 Atl. 77 (1910)]." *Id.* at 438, 91 Atl. at 432. The court took the position that plaintiffs were induced to part with their stock by the false representations that all were selling at the same price. This analysis, however, would not appear to be applicable to the two plaintiff-shareholders, who resisted until the merger. *Cf. Beeber v. Wilson*, 285 Pa. 312, 131 Atl. 854 (1926).

The court rejected the contention of the defendants that they had sold their stock for \$290 per share—a sum equivalent to the approximate proportion which each share of defendants bore to the entire amount received by them. It treated the control fund as a secret consideration paid to defendants for the purpose of gaining immediate control of the board of directors, accepting the following statement of the chancellor who heard the case:⁹⁵

If the defendants had sold their shares at \$290 . . . , the vendees would then hold a majority of the stock and the control at any stockholders' meeting would vest in them, as an incident to their purchase. But the defendants sold this control as their individual estate and received a special compensation for it, . . . the "bonus" was paid to them in part for this control of the board, and the defendants delivered the consideration forthwith The resignations did not follow as a consequence of the sale of their stocks, but as a means and requirement to secure the "control fund" The resignations antedated the parting with their stocks

The decision, if properly projected against the other cases under discussion, permits the following assessment of the situation: First, while the theory of sale of office was treated as crucial by the court in the *Porter* case, it is doubtful whether the result would have been different if the directors had continued in office and had participated in the corporate transactions as did the directors in the *Seltzer* case. Second, again the sellers and buyers themselves separated control value from investment value. Indeed, the defendants initially admitted that the price fixed for the stock was \$165 per share, and contended that the price which they received for parting with control was entirely a "private business matter." But all this was simply a strategic blunder which, prior to *Feldmann*, could have been obviated by proper staging and pleading. It is one of the significant aspects of *Feldmann* that it blocked this avenue of escape by placing upon the director-controlling shareholder the burden of showing the value of the control block shorn of the appurtenant power of control. Third, the great contribution of the *Porter* case lies in the fact that the court there did not permit the concept of separate entity to operate so as to prevent direct recovery by the shareholders who had disposed of their stock as a part of the transaction or subsequently as a consequence of the merger.

Reverting to the *Feldmann* case, after judgment in the trial court and pending reversal on appeal, Merritt-Chapman & Scott made a general offer to all shareholders of Newport in connection with its purchase of Newport's shares held by Wilport at \$10.50 per share and shareholders representing all but about 5 per cent of the Newport shares accepted the offer.⁹⁶ Yet the court, although the action was derivative, held that (in preference

⁹⁵ *Porter v. Healy*, 244 Pa. 427, 433, 91 Atl. 428, 430 (1914).

⁹⁶ See note 12 *supra*.

to a recovery by the corporation, as is normally done in a derivative suit) the plaintiffs "and those whom they represent" should share personally in the recovery, "since the only alternative, recovery for the corporation as a whole," would give the purchaser (Wilport) or its successors (Merritt-Chapman & Scott) a windfall to which they clearly were not entitled.⁹⁷ There is, of course, substantial authority for awarding a personal rather than a corporate recovery in a "pure" derivative suit under exceptional circumstances.⁹⁸ But, assuming the correctness of the decision as a matter of substantive law, could there have been any reason for excluding those shareholders who later disposed of their shares (as a part of the over-all transaction) from sharing in the recovery? As between Feldmann and his associates, the "corporation as a whole," and the shareholders who disposed of their shares pending appeal, who should share in the control fund? And does a judgment in favor of the selling shareholders point the way to the further conclusion that the cause of action is, essentially, to redress a breach of fiduciary duty on the part of Feldmann toward the outside shareholders, the real parties in interest?⁹⁹ Until this question is ultimately resolved a plaintiff, in a proper case, where local procedure so permits, should join an individual or class action against the individual defendants for redress of a grievance personal to himself as a stockholder with a count which asserts a corporate right of action, in which he also asks for personal

⁹⁷ See note 17 *supra*.

⁹⁸ This may be done: (1) at a shareholder-plaintiff's request, where the wrongdoing defendants own substantial amounts of stock so that a corporate recovery would result largely in the defendants reimbursing themselves to the extent of their stock interest, *Brown v. DeYoung*, 167 Ill. 549, 47 N.E. 863 (1897); see *Di Tomasso v. Loverro*, 250 App. Div. 206, 293 N.Y. Supp. 912 (2d Dep't 1937), *aff'd*, 276 N.Y. 551, 12 N.E.2d 570 (1937); *cf. Eshleman v. Keenan*, 22 Del. Ch. 82, 194 Atl. 40 (1937), *aff'd*, 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); (2) where the controlling shares owned by the defendants have been sold to new interests in an arm's length transaction and a corporate recovery would result in a windfall to the purchasers, who would thus get back indirectly a part of the purchase price, *Matthews v. Headley Chocolate Co.*, 130 Md. 523, 100 Atl. 645 (1917); see *Capitol Wine & Spirit Corp. v. Pokrass*, 277 App. Div. 184, 98 N.Y.S.2d 291 (1st Dep't 1950), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951); (3) at the defendant's request where some of the complaining shareholders either were themselves wrongdoers or were not otherwise deserving of equitable relief, *Matthews v. Headley Chocolate Co.*, *supra*; *Joyce v. Congdon*, 114 Wash. 239, 195 Pac. 29 (1921); (4) where shareholders other than the plaintiff waive their rights and the corporation has been liquidated so that it has only a formal existence, *Bailey v. Jacobs*, 325 Pa. 187, 189 Atl. 320 (1937). See *Kroese v. General Castings Corp.*, 179 F.2d 760, 764 n.5 (3d Cir. 1950), *cert. denied*, 339 U.S. 983.

Where a minority shareholder has been induced to dispose of his shares, as a result of which, not only is he stripped of his right to bring a derivative suit, but a corporate recovery could not possibly benefit him, an individual action may be permitted. See *Hammer v. Werner*, 239 App. Div. 38, 265 N.Y. Supp. 172 (2d Dep't 1933).

⁹⁹ See note 17 *supra*. On the other hand, it might be argued that in the event of insolvency the cause of action should be treated as derivative, so that creditors would have resort to the control fund. In such event the fiduciary obligation would be enforceable by the receiver or by the trustee in bankruptcy. *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

recovery.¹⁰⁰ Essentially, this was done in *Benson v. Braun*,¹⁰¹ now pending in the New York courts.

C.

Theory of Abuse of Power: the Border-Line Cases

As a matter of basic policy should the owner of a controlling block of shares who sells them to outsiders at a price not made available to all other shareholders be compelled to pay over to the corporation or to the other shareholders any premium which he receives above the investment value of the shares? One can imagine situations where the controlling shareholder simply takes a speculative position in the shares and refrains from taking direct command of the corporate management. Suppose, for example, that A, B and C each own one-third of the shares of Loss Corporation. The corporation has operating loss carry-overs of substantial value. It has property which has diminished in value below cost, so that there is a potential tax loss on its sale. In addition, some of this property is depreciable, so that there is a current depreciation deduction in excess of actual depreciation, based upon existing values. Assume further that a Cash McCall,¹⁰² a gay adventurer in pursuit of profit, ascertains that if he can acquire the shares of A, B and C at the current price (which does not reflect the non-balance sheet asset of Loss Corporation arising from its tax position) he can resell these shares at a premium to Y Corporation, which will then effect a merger and thus acquire the tax benefit.¹⁰³ McCall purchases the shares of A and B, but C hangs on to his holdings. McCall then resells the control shares

¹⁰⁰ There is a conflict of authority as to the propriety of joinder of individual and derivative actions. Joinder was permitted in *Willcox v. Harriman Securities Corporation*, 10 F. Supp. 532 (S.D.N.Y. 1933) (under old Federal Equity Rule No. 26). See new FED. R. CIV. P. 18 and 23; 3 MOORE, FEDERAL PRACTICE § 18.04[2] and n.8 (1948); Hornstein, *Legal Controls for Intracorporate Abuse—Present and Future*, 41 COLUM. L. REV. 405, 415, 416 n.76 (1941). *Contra*, *Shenberg v. De Garmo*, 61 Cal. App.2d 326, 143 P.2d 74 (1943); *Whitney v. Whitney*, 296 Mass. 13, 4 N.E.2d 438 (1936); *Brock v. Poor*, 216 N.Y. 387, 111 N.E. 229 (1915); 13 FLETCHER CYC. CORP. § 6011 (perm. ed. 1943).

¹⁰¹ 145 N.Y.S.2d 711 (App. Div. 1955).

¹⁰² See HAWLEY, CASH MCCALL 142 *passim* (1955), a fascinating novel of a "twentieth century adventurer who carries on [a] fabulously successful [business] of buying and selling of companies." McCall is an "operator" who specializes in combining weak with strong companies in order to take advantage for tax purposes of an operating loss carry-over or of a disparity between actual and book values. He is to be distinguished from a "liquidator," who engages in acquiring control of corporations whose stocks are quoted at prices below their values based upon the underlying corporate assets. Such a situation may arise from a niggardly dividend policy or from failure of the stock prices to reflect inflation. The "liquidator" proceeds to dismember the company by selling off the assets and liquidating, taking advantage of the capital gain rates. See generally, Gower, *Corporate Control: The Battle for the Berkeley*, 68 HARV. L. REV. 1176 (1955). In case of liquidation, however, outside stockholders share ratably in any profit in accordance with their stock interests.

¹⁰³ *Cf. Mills v. Sarjem Corporation*, 133 F. Supp. 753 (D.N.J. 1955).

to Y Corporation at a profit which represents the capitalized value of the power to acquire the tax benefit. Must he share this profit with C on the theory that he has, in effect, sold a corporate "asset," or seized a "corporate opportunity," or at least seized an "opportunity," the profits from which he must share with C, the outside shareholder?

It would seem entirely plausible for a court to allow recovery. As Berle argues (and this is the heart of his theory): "... a position of 'control' is a valuable piece of property to its holder, and [is] so regarded; its value arises out of the ability which the holder has to dominate property which in equity belongs to others. And [writing in the year 1932, he adds,] the law thus far has been unable to deal with the situation."¹⁰⁴

Now let us envisage a variety of factual situations preceding the merger. Suppose, at the next annual shareholders' meeting, McCall voted for the continuation of the existing directors consisting of A, B, and C. Or suppose he elected his lawyer, his accountant, and a business associate to the board.¹⁰⁵ Or suppose he himself went on the board. Or finally, suppose that, in addition to going on the board, he also took the role of president. Under each of these possibilities assume further that McCall immediately effected the sale of control shares to Y Corporation.

If McCall has sold the control shares per se and has not delivered the board of directors, under the laws of most states none of the existing directors could be removed from office before the expiration of his term, except for cause.¹⁰⁶ Thus, it might be difficult for Y Corporation to gain immediate control of the board of directors until the next annual meeting, unless failure of the Loss Corporation board to approve the merger could be regarded as a ground for removal. Nevertheless, should McCall be liable in these circumstances?

On the other hand, if McCall has delivered resignations of the directors, is he now in a more vulnerable position? Has he now breached a fiduciary duty to the corporation? To C, the outside shareholder? Would it make any difference whether Y Corporation was willing to purchase all of the shares or was willing to purchase only those shares necessary to effect the merger? Should the court use the technique suggested by the *Feldmann* case and place the burden upon McCall to establish what value the shares sold by him possessed when shorn of the power to divert the tax loss?

Whether or not McCall may have assumed direct managerial control, as a matter of principle, there seems no substantial basis for permitting him

¹⁰⁴ BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 244 (1932).

¹⁰⁵ *Cf. Greene v. Allen*, 114 A.2d 916, 917, 920 (Del. Ch. 1955).

¹⁰⁶ Under some state statutes a majority of the voting power may remove the entire board without cause. See, for example, CAL. CORP. CODE § 810; MINN. STAT. § 301.29 (1949); PA. STAT. ANN. tit. 15, § 2852-405 (Purdon 1938).

to abuse his control position by taking the full profit on the sale of Loss Corporation. Since the very object of sale of control, rather than merger, is for the purpose of intercepting the profit, why should McCall be exempt from liability merely because he refrains from actually assuming the role of director or officer or otherwise exerting voting power? Indeed, despite any protestations, has he not in fact exploited "corporate powers"? When we compare the underlying bases of the "sale of office" and "corporate transaction" cases, we find a single controlling principle, the abuse of power by the possessor of "control."

Corporate powers are vested in the management, but they may also be exercised by a dominant shareholder. When directors and officers sell their positions and thus control, either through the guise of a stock sale or otherwise, they are said to have reaped a personal profit as a result of abuse of "official position." Yet, when the possessor of the ultimate power of control, the majority shareholder, sells his shares per se at a premium above the investment value, he too abuses the power which goes with his holding. He too appropriates a personal profit from selling control over property, which, in equity, belongs to others. For all practical purposes, he too exploits corporate powers—powers which he holds in trust for the corporation and the other shareholders.¹⁰⁷

It is not surprising, therefore, that many informed businessmen and corporate lawyers instinctively feel that when the dominating shareholder receives an offer to purchase a controlling interest it should be communicated to the other shareholders and they should be given an opportunity to deal on an equal basis. In other words, it is believed to be improper to derive a personal profit from trading in control.

V

CRACKS IN THE JUDICIAL FOUNDATION FOR THE TRADITIONAL THEORY

Assuming the soundness of the abuse of power theory, what is the likelihood that the courts will commit themselves more definitely to this view, either now or eventually? The answer to this question would seem to depend, in part, upon the conclusiveness of the precedents supporting the orthodox view that the controlling shareholder may reap a personal profit on the sale of control. When one examines the cases it is astonishing how little authority exists in support of the orthodox view. *Stanton v. Schenck*,¹⁰⁸ which evoked the views expressed by Berle,¹⁰⁹ actually did not deal at all

¹⁰⁷ Cf. *Pepper v. Litton*, 308 U.S. 295 at 306 (1939).

¹⁰⁸ 140 Misc. 621, 251 N.Y. Supp. 221 (Sup. Ct. 1931).

¹⁰⁹ See BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 243 (1932), discussing the preliminary opinion on a motion to dismiss. *Stanton v. Schenck*, 142 Misc. 406, 252 N.Y. Supp. 172 (Sup. Ct. 1931).

with the problem. The case concerned Loew's, Incorporated, the theatre chain, which had been founded by Marcus Loew. Upon his death Mrs. Loew, his wife, and her family owned in round numbers 233,000 of the corporation's voting shares out of a total of 1,350,000. Loew's top management group consisted of Schenck, Bernstein, and Arthur Loew, son of the founder, all of whom were officers and directors and had worked closely with Marcus Loew in building the business.

Fox Theatres Corporation, Loew's principal competitor, approached Mrs. Loew through Schenck to induce her to sell a controlling stock interest. Mrs. Loew offered to sell the 233,000 shares owned by her immediate family on condition that the purchaser acquire an aggregate of 400,000 shares, which would also include the shares of her grandsons and the close business associates of her husband. The price asked was \$125 per share (twice the price on the open market), of which \$102.50 would go to the owners of the shares; the balance was to be paid to Schenck, Bernstein, and her son Arthur as a bonus for their work in assisting her husband in founding the business. Fox consented to this arrangement, whereupon Schenck, Bernstein, and Arthur Loew proceeded to accumulate the 400,000 shares, some purchases being made by them in the open market. The 400,000 shares (approximately 45% of the voting power) were then transferred to Fox Theatres. The net effect was that the control block *per se* got a price which included a premium above the market price and that in addition Schenck, Bernstein, and Arthur Loew received a bonus of approximately \$9,200,000 from the proceeds.

None of these beneficiaries participated actively in the negotiations leading toward the sale; neither did they nor the other directors of Loew's resign from the board. At the next annual meeting only two representatives of the Fox Interests were elected directors, although in view of their cumulative voting rights they would have been able to elect five of the twelve directors.

Minority shareholders of Loew's brought a derivative suit, naming Schenck, Bernstein, and Arthur Loew as the sole individual defendants. Plaintiffs' cause of action was that defendants had conspired with the Fox interests to turn over control of Loew's to its chief competitor, reduce Loew's to a state of vassalage, and strengthen the position of Fox in the motion picture industry. This was alleged to have been accomplished by agreeing with Fox to accumulate 400,000 shares of stock in Loew's (including that of the controlling management) in consideration of \$125 per share, of which defendants received a secret bonus of \$9,200,000 at the expense of the corporation and its shareholders. The further claim was made that defendants were continued in lucrative positions and assumed the status of vassals or dummies of Fox, thereby breaching their fiduciary duties to

the corporation and shareholders. It is significant that none of the other selling shareholders (including Mrs. Loew) were made defendants for it shows that plaintiffs' theory was not based upon sale of control shares at a premium.

At the close of plaintiffs' case the court granted defendants' motion to dismiss, holding that plaintiffs had failed to establish their claim. The court found that Mrs. Loew and not defendants had arranged for the sale of the stock and payment of a part of the proceeds to them. No showing was made of any change in the policies or methods of conducting the business, or loss or damage to the corporation (corporate profits substantially increased), or that defendants in any way subverted the interests of the corporation. In the course of its opinion the court ventilated the question whether defendants, as officers or directors, were required to account for any profit made from the sale of their stock above market quotations, but found no abuse of power or position. In discussing the charge of conspiracy, the court stated:¹¹⁰

Mrs. Loew had an inalienable right to sell her own stock upon any terms she demanded and could obtain. She could impose upon the buyer as one of the conditions that he purchase the stock of her friends and the business associates of her husband. She could fix the price and she was also entitled to do whatever she desired with the proceeds. Plaintiffs have failed to successfully sustain the burden of proof as to this [conspiracy] charge.

The court then turned to the problem whether the directors, apart from any special circumstances of bad faith or proof of injury to the corporation, may be compelled to account for any profit on the sale of their stock above the current quotations. After alluding to the cases in which a director who obtains a secret gift from a third party in handling a corporate transaction has been held accountable to the corporation, the court stated:¹¹¹

Here, there is not the slightest evidence that any corporate property was involved in the transaction, *nor is there any proof that by their conduct the directors deprived the corporation of a profitable and desirable deal*. No one will argue that the holder of a large block of the stock of a corporation would be under a duty to account for his profit to the corporation. As such holder he might be in a position to command a considerable premium above current prices in a favorable market. The advantage would be entirely his, for which he would in no way be compelled to respond to the corporation. If it is granted that a director may freely sell his own stock, it must follow that he may benefit from the advantage due to his holding of an exceptionally large block of stock.¹¹² Possibly, evidence of unfair dealings and con-

¹¹⁰ 140 Misc. at 628, 251 N.Y. Supp. at 228.

¹¹¹ *Id.* at 633, 251 N.Y. Supp. at 233. (Emphasis added.)

¹¹² Even if one were to cast doubt on the defensibility of this broad proposition, the acceptance of the bonus by the directors in the instant case can by no stretch of the imagination be deemed to be an abuse of position, since they themselves had not bargained for it and had received it as a reward for past services.

spiracy, such as are charged in the complaint, might make a difference; but in view of the failure of proof in that direction, we are relegated to the abstract principle as to the right of a director to sell his stock freely to the best advantage. This he may do. Consequently, it must follow that there is nothing for which the defendant directors must account to the corporation.

By failing to join Mrs. Loew as a defendant plaintiffs apparently conceded the proposition that the controlling shareholder may derive a premium on the sale of control. The whole theory of plaintiffs' case was built upon an attempt to prove a conspiracy by the Fox interests and defendant directors, by which the latter accumulated and turned over to a competitor a controlling interest in their corporation in consideration of the payment of the bonus of \$9,200,000. This conspiracy was not proved.¹¹³

Aside from *Tryon v. Smith*,¹¹⁴ previously discussed, only two cases might, with some justification, be thought to lend support to the view that a controlling shareholder is not accountable to the corporation or other shareholders on the sale of control at a premium.

In *Keely v. Black*¹¹⁵ defendant was president and director of Farmers' Company, a local telephone corporation which had an exclusive right by contract with the Bell Companies of furnishing telephone services within a district. Farmers' had 2,000 shares outstanding, of which defendant owned 500 shares and controlled others belonging to his family. At the start of World War I, the government commenced to build a large army base within the district, which required the installation of a telephone system at the base. Bell desired to take over this operation. It secretly agreed with defendant that Bell should not only be freed from the effects of its exclusive grant to Farmers' of the territorial rights to the army base but that defendant should deliver to them at least 55 per cent of Farmers' stock at \$44 per share. Bell further agreed (on a formula basis) to pay defendant a bonus up to \$45,000 for the delivery of additional shares pursuant to the contract. Defendant then proceeded to make a galloping acquisition of the shares, gathering in all of them except 80 held by plaintiff, who hung on despite considerable pressure by defendant. Upon gaining control, defendant reconstituted the Farmers' board of directors. The board then released the territorial rights to Bell and defendant delivered the shares to Bell and received a bonus of \$28,635.

Plaintiff, the remaining minority shareholder, brought a derivative suit against defendant, the theory being that the bonus was paid in part for the

¹¹³ The court also noted that if, in accordance with plaintiffs' request, recovery were decreed to the corporation, it would to a great extent result in a windfall to the Fox interests. This result, of course, could have been obviated by awarding a personal recovery, as was done in *Feldmann*.

¹¹⁴ 191 Ore. 172, 229 P.2d 251 (1951). See note 85 *supra*.

¹¹⁵ 91 N.J. Eq. 520, 111 Atl. 22 (1920), *reversing* 90 N.J. Eq. 439, 107 Atl. 825 (1919).

release of territorial rights and in part for control of the company. The trial court awarded a corporate recovery, holding that defendant breached a fiduciary relation to the corporation and to the outside shareholders by clandestinely dealing with the corporate assets for his private profit. The New Jersey Court of Appeals and Errors reversed and denied any recovery. The court observed that defendant "was not dealing with the property of the company, but with his own, the title to some of which he derived from other stockholders."¹¹⁶ Moreover, the court also felt impelled to deny relief because the corporate recovery awarded by the trial court resulted in a large windfall for Bell, the purchaser of control. Both bases of the decision seem clearly contrary to the position taken in a number of the cases previously discussed, including the *Feldmann* case, and it is significant that neither of the opinions in the latter case made any mention of *Keely v. Black*.

The main support for the general rule is generally thought to be *Levy v. American Beverage Corp.*¹¹⁷ There the principal defendant, McCullough, owned or through his family and personal corporations controlled 72,000, or 53 per cent, of the shares of American. Evidently the remaining shares were scattered; the stock was listed on the New York Curb Exchange, although it was inactive. Defendant negotiated the sale of the controlling shares to one Feinberg, who proposed to effect a merger between American and another corporation controlled by him. These negotiations fell through, partly because defendant suspected the integrity of the proposed purchaser. Later, defendant gave an option to purchase the shares to Clark, apparently a reputable banker. The option price was \$250,000, or about \$3.50 per share. The cost of the shares to the selling shareholders had been about \$5.60 per share and the book value was \$4.31, based upon very conservative accounting figures, although they were sold on the exchange at times as low as \$1.125. When the option was about to expire, McCullough granted an extension, although he had previously discovered that Feinberg was back in the picture and suspected that Clark might be acting on his behalf. The transaction was consummated just prior to the annual meeting. By this time it was apparent that Clark was representing Feinberg, although it appears that McCullough did not know that Feinberg still intended to merge American with his corporation rather than with certain other corporations as Clark had intimated. McCullough delivered proxies covering his control shares to Feinberg, as he was apparently required to do under the option contract, but he did not turn over proxies which he had previously secured from the outside shareholders in anticipation of the meeting.

¹¹⁶ *Id.* at 523, 111 Atl. at 23.

¹¹⁷ 265 App. Div. 208, 38 N.Y.S.2d 517 (1st Dep't 1942), *reversing Levy v. Feinberg*, 29 N.Y.S.2d 550 (Sup. Ct. 1941).

Feinberg then took command. He elected a new board of directors at the annual meeting, although McCullough caused the proxies in his hands to be voted for the old board, in accordance with the solicitation letters. Feinberg immediately caused the corporations to be merged (American continuing as the surviving corporation), using the funds of American to pay for the control shares as well as to bail out his personal corporation, which was in great financial difficulties. The result was disastrous for American and its outside shareholders.

The theory of the cause of action, a derivative suit, was that defendants, the selling shareholders, had breached a fiduciary duty to the minority: (1) by failing to make a proper investigation of the moral and financial responsibility of the purchaser before transferring control; and (2) by deriving a personal profit from the sale of control at a premium above the market price for which they should account.

In reversing judgment for plaintiff on both scores, the appellate court took the position on the first point that the trial court was not justified in drawing inferences of actual fraud, constructive fraud, or negligence on the part of McCullough. The court placed considerable weight on the fact that at the time of the closing the old board had refused to resign, and that Feinberg only got control of the management by electing a new board at the annual meeting. The court also stressed the fact that American occupied a plant which was under a very favorable long-term lease with a McCullough-controlled corporation. If McCullough had been forewarned of an intention to loot the corporation, the court thought it unlikely that he would have disregarded the effect this would have on the long and lucrative lease. In effect, the appellate court felt that McCullough had been greatly misunderstood by the trial court. The court pointed out that there was no evidence of a conspiracy fraudulently to turn over control to a purchaser for the purpose of looting.

Moreover, the court pointed out, plaintiff's whole complaint was based upon the alleged breach of fiduciary duties. It took the position that a controlling shareholder is not a fiduciary in the sale of his holdings. Indeed, the court intimated that the only basis for recovery in this situation was proof of wanton and fraudulent destruction of the rights of the minority. The court then observed:¹¹⁸

A majority stockholder does not become a fiduciary for other stockholders by reason merely of ownership of his stock. It is only where he steps out of his role as a stockholder, and acts in the management and conduct of the corporation, with disregard of the interests of the corporation and of the minority stockholders that he is said actually to become a fiduciary instead of a mere stockholder. . . . We may assume that he may be held as fiduciary

¹¹⁸ 265 App. Div. at 216-18, 38 N.Y.S.2d at 525-26. (Emphasis added.)

when he is in active charge of corporate affairs, and induces a minority stockholder to sell his holdings, concealing the true condition of corporate finances for the purpose of making a personal profit. (See *Sautter v. Fulmer*, 258 N.Y. 107.)

.... The present case does involve a charge that the majority stockholders benefited at the expense of the minority. That charge, however, rests solely on the claim that more was received by appellants for their stock than it was bringing in the open market. *The difference between market price and liquidating value would indicate that the market price of small lots of stock did not reflect its intrinsic worth, especially of controlling stock.* Realization of more than the market price would not, under the circumstances, be indicative of fraud, nor afford the minority shareholders any right of action. Nor would the fact that purchasers were willing to pay a larger price to one holding control necessarily make the receipt of an increased price improper or indicate any unlawful intention on the part of the purchasers. Control might have lawful advantages. For instance, if corporate control for the purpose of merger, or some similar object, was desired by the purchasers for legitimate purposes, undoubtedly they would pay more for a controlling interest. We see no reason why the value of control would not be a lawful property right of the controlling stockholders, at least to the extent that it is reflected in the price they may obtain for their stock in an honest sale. *In any event, in view of the liquidation value of the stock involved in the present case, the sum realized here could not be said to be so excessive as to indicate any danger signal.*

In commenting on the views thus advanced, it appears that the court equated intrinsic and liquidation value with investment value and that, while the opinion contains some very broad and not clearly defined propositions, the salient point for the actual disposition of the case was the fact that the shareholder actually received substantially less than what the court thought to be the investment value. In view of this difference, the court felt no need to define clearly the elements accounting for the "intrinsic worth" of the stock "especially of controlling stock." From the point of view taken in this article, however, caution is required lest investment value of controlling stock be inflated by elements which properly must not be included. Expert testimony, therefore, should always be carefully scrutinized as to its proper basis.¹¹⁹ Moreover, where the transferor of control

¹¹⁹ In the *Feldmann* case, Dr. Badger, defendants' expert, found a per share value of the control shares of between \$18.80 and \$22.55, as compared with \$20, the sale price of the control block. Furthermore, it was his position that "because the block of stock was sufficiently large to give the holder control of the corporation, it should be valued as a proportionate part of the value of the whole business, and not on the basis of the value of the individual shares to a small investor." 129 F. Supp. at 139. It will be recalled, however, that at the time of the sale of the control block, the market price was about \$10. Moreover, in a little over three years, (after the trial and pending appeal) Merritt-Chapman & Scott bought 95% of the stock at \$10.50 per share. Did Dr. Badger, in arriving at the value of the enterprise, in effect include a gray market figure in his computations? See notes 9 and 12 *supra*.

stock, receiving more than the market price, claims that all or a part of the excess is attributable to the investment value, under the *Feldmann* rule, he should bear the burden of proof for the truth of his assertions.

It is perhaps again no mere accident that both the majority and dissenting opinions in the *Feldmann* case made no reference to *Levy v. American Beverage Corp.*

Although it must be concluded from the review of the cases that the so-called conventional theory rests on feet of clay and that the *Feldmann* case merely continues a course already marked by previous case law, its full thrust is yet to be determined. Indeed, the majority revealed some indecision as to the precise limits of the case by the following statement:¹²⁰

We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do this with impunity when the buyer is an interested customer, actual or potential, for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent *unusual* profit to the fiduciary who has caused the sacrifice, he should account for his gains. So in a time of market shortage, where a call on a corporation's product commands an unusually large premium, in one form or another, we think it sound law that a fiduciary may not appropriate to himself the value of this premium. Such personal gain at the expense of his co-adventurers seems particularly reprehensible when made by the trusted president and director of his company. In this case the violation of duty seems to be all the clearer because of this triple role in which *Feldmann* appears, though we are unwilling to say, and are not to be understood as saying, that we should accept a lesser obligation for any one of his roles alone.

Under this caveat, it is not clear whether a controlling shareholder may insulate himself from liability by staying off the board and exerting no direct managerial powers.

CONCLUSION

This survey suggests that the path of the law is less well marked out and far more meandering than superficial appraisal would suggest. In fact, prior to the *Feldmann* case, it was hardly more than the primeval "trial of the calf" in Max Radin's well-chosen simile.¹²¹

Its final shape and direction must, of course, be founded upon broad considerations of policy. It may be argued, on the one hand, that a controlling shareholder should have the same freedom to trade in his corporation's shares that the law allows to the outside shareholders, and that to hold otherwise fetters the control shares with restraints not imposed upon other

¹²⁰ 219 F.2d at 178. (Emphasis added.)

¹²¹ Radin, *The Trail of the Calf*, 32 CORNELL L.Q. 137 (1946).

kinds of property. On the other hand, it may be pointed out that control shares in the modern corporation possess their special value from the strategic position which is enjoyed by them solely because of the collective powers inherent in the corporate structure. These shares provide a leverage for enabling the corporate insiders to reap profits which in fairness should be shared with the other stockholders. It would be unfortunate if the courts were to hold that what the control group may not do directly, they may do indirectly by masquerading the package deal as a mere sale of stock.

The cases reveal that the courts are becoming increasingly aware of the economic aspects of trading in control and are manifesting a greater willingness to protect the minority shareholders against overreaching by a powerful majority. How far the courts will ultimately go in resolving the manifold issues cannot be predicted with any certainty. It is to be hoped that either now or eventually the courts will give legal recognition to the widespread belief in the business community that a sale of control shares should be accompanied by a general offer, and thus reject the philosophy that, in this situation, the right to a special profit is simply a perquisite of control.