

California Law Review

VOL. 57

JANUARY 1969

No. 1

Copyright © 1969 by California Law Review, Inc.

The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking

Melvin Aron Eisenberg*

TABLE OF CONTENTS

I A GENERAL THEORY	4
A. A NORMATIVE MODEL OF VOTING RIGHTS IN PRIVATELY HELD CORPORATIONS	7
B. A NORMATIVE MODEL OF VOTING RIGHTS IN PUBLICLY HELD CORPORATIONS	15
1. Considerations of Public Policy	15
(a) "Shareholder democracy"	15
(b) Client-group participation	16
(c) Managerialism	21
2. Managerial Conflicts of Interest	27
3. Shareholder Expectations	33
(a) The AT&T myth	33
(b) The fallacy of "the average shareholder"	44
(i) The proprietary principle of corporate law	44
(ii) Institutional investors as shareholders in publicly held corporations	46
(A) The magnitude of institutional shareholdings	46
(B) The role of the institutional investor as a shareholder	48
4. A Normative Model	53
C. THE STATUTORY MODELS OF DECISIONMAKING	60
1. The Statutory Decisionmaking Patterns	61
(a) Mergers	61
(b) Sale of substantially all assets	64
(c) Amendment of the certificate of incorporation	66
(d) Voluntary dissolution	67
2. The Statutory Coverage	68

D. THE PLACE OF THE APPRAISAL RIGHT IN A NORMATIVE CORPORATE MODEL	71
1. Privately Held Corporations	79
2. Publicly Held Corporations	81
II THE MODERN FUNDAMENTAL CHANGES: VOTING AND APPRAISAL RIGHTS IN CORPORATE COMBINATIONS AND DIVISIONS	86
A. LEGAL PRINCIPLES GOVERNING THE DISTRIBUTION OF POWER BETWEEN MANAGEMENT AND SHAREHOLDERS WHEN THE CORPORATE STATUTES ARE SILENT	86
B. CORPORATE COMBINATIONS	91
1. The Stock Modes	92
(a) <i>The problem under traditional corporate statutes</i>	93
(b) <i>The meaning of "merger"</i>	100
(c) <i>Tax treatment of the combination problem</i>	105
(d) <i>Accounting treatment of the combination problem</i>	108
(e) <i>Lines of solution</i>	112
(i) <i>Shareholders of the transferor in stock-for-assets combinations</i>	112
(A) <i>The meaning of "sale"—a continuity-of-interest test</i>	112
(B) <i>The "indicia of a merger" test</i>	115
(C) <i>A test based on continuity of interest and relative size</i>	116
(D) <i>A statutory solution</i>	117
(ii) <i>Shareholders of the survivor in stock-for-assets combinations</i>	118
(A) <i>Stock-for-assets combinations viewed as purchases</i>	119
(B) <i>Stock-for-assets combinations viewed as an issuance of stock by the survivor</i>	119
(C) <i>Stock-for-assets combinations viewed as mergers</i>	120
(D) <i>A suggested solution under the traditional statutes</i>	120
(E) <i>New statutory solutions</i>	121
(iii) <i>Shareholders of the transferor in stock-for-stock combinations</i>	131
(iv) <i>Shareholders of the survivor in stock-for-stock combinations</i>	138
(A) <i>Under the traditional statutes: a step-action theory</i>	138
(B) <i>Under common law principles</i>	141

(C) <i>A theory of proprietary limitations on statutory board powers</i>	142
(D) <i>A revised de facto theory</i>	145
(E) <i>A statutory solution</i>	147
2. The Cash Modes	147
(a) <i>Cash-for-assets combinations from the transferor's perspective</i>	148
(b) <i>Cash-for-stock combinations from the transferor's perspective</i>	149
(c) <i>Cash-for-assets combinations from the survivor's perspective</i>	149
(d) <i>Cash-for-stock combinations from the survivor's perspective</i>	150
C. CORPORATE DIVISIONS	150
1. Sell-offs	150
(a) <i>Under the traditional corporate statutes</i>	151
(i) <i>Where the retained assets do not include a significant business</i>	151
(ii) <i>Where the retained assets do include a significant business</i>	154
(b) <i>Under common law principles</i>	156
(c) <i>A statutory solution</i>	157
2. Corporate Contractions or Partial Liquidations	157
(a) <i>Under the traditional statutes</i>	158
(b) <i>Under common law principles</i>	159
(c) <i>An excursus: the statutory partial liquidation provisions</i>	163
(i) <i>The Internal Revenue Code</i>	163
(ii) <i>The Illinois statute</i>	167
(iii) <i>The Pennsylvania statute</i>	168
3. The Creation of a Subsidiary	169
(a) <i>Under the traditional corporate statutes</i>	170
(b) <i>Under common law principles and de facto theory</i>	171
4. Spin-offs, Split-offs, and Split-ups	174
(a) <i>Under the traditional corporate statutes</i>	176
(i) <i>The transfer</i>	176
(ii) <i>The distribution</i>	176
(A) <i>Split-ups</i>	176
(B) <i>Split-offs</i>	177
(C) <i>Spin-offs</i>	177
(b) <i>Under common law principles</i>	177
(c) <i>Under de facto theory</i>	178
(d) <i>Statutory solutions</i>	179
CONCLUSION	180

I

A GENERAL THEORY

Corporate law is constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those participating in the institution, and to delimit the powers of the institution vis-a-vis the external world.¹ Nevertheless, the way in which the law ought to distribute decisionmaking power between management² and shareholders in the business corporation has never been well articulated. There does exist a more or less standardized model of corporate decisionmaking—what we will call the received legal model—whose general outlines are well known. For decisionmaking purposes, the corporation is said to consist of a board of directors, which manages the corporation's business; officers, who, as agents of the board, execute its bidding; and shareholders, who elect the board and determine "major corporate actions," or "fundamental" or "extraordinary" or "unusual" changes:

The standard operating procedure for corporations, frequently referred to as the corporate norm, might be described as pyramidal in form. At the base are the shareholders whose vote is required to elect the board of directors and to pass on other major corporate actions The next level is represented by the directors who constitute the policy-making body of the corporation, and select the officers, annually as a rule. The keystone of corporate procedure is the provision common to most corporation laws that "the business of a corporation shall be managed by its board of directors." Finally, at the top of the pyramid are the officers who have some discretion but in general are deemed to execute policies formulated by the board.³

* A.B. 1956, Columbia University; LL.B. 1959, Harvard University. Acting Professor of Law, University of California, Berkeley.

1. *Cf.* J. DAVIS, *CORPORATIONS* 10-11 (1905); R. ELLS, *THE GOVERNMENT OF CORPORATIONS* 31-122 (1962); F. MECHEM, *OUTLINES OF THE LAW OF AGENCY* 2 (4th ed. P. Mechem 1952); Brewster, *The Corporation and Economic Federalism*, in *THE CORPORATION IN MODERN SOCIETY* 72-76 (E. Mason ed. 1959).

2. For purposes of this Article, no distinction will be drawn between the legal and factual powers of directors and those of officers, and the term "management" will therefore be used interchangeably with the term "directors." I intend to examine the distribution of power within management in a subsequent Article.

3. R. BAKER & W. CARY, *CORPORATIONS—CASES AND MATERIALS* 89 (3d ed. 1959). Similarly, Ballantine:

"The board of directors is the supreme and original authority in matters of regular business management. . . .

. . . .

"The authority of the directors is restricted to the management of the regular business

Perhaps the most important aspect of this model is its distinctive tripartite form. Most business organizations have two basic elements: ownership, and those who act as ownership's agents. Reduced to their simplest form, therefore, most business organizations might be portrayed by a two-level model. Under the received legal model, however, no one acts as agent of the shareholders—that is, of ownership. The officers are agents of the board. The board, in turn, is conceived to be an independent institution, not directly responsible to shareholders in the manner of an agent. For example, the authority of an agent can normally be terminated by the principal at any time,⁴ but directors are normally removable by shareholders only for good cause shown.⁵ An agent must normally follow his principal's instructions,⁶ but shareholders have no legal power to give binding instructions to the board on matters within its powers.⁷ In short, in contrast to the legal models of most other business organizations, which set up one definitive power center—ownership—the received

affairs of the corporation, unless more extensive power is expressly conferred. Their authority does not extend to fundamental changes in the character or organization of the corporation . . . unless by express provision, for such matters do not relate to ordinary business." H. BALLANTINE, CORPORATIONS 119-20 (rev. ed. 1946). "Extraordinary and unusual changes in corporate organization, not relating to the ordinary business, must be authorized by . . . the shareholders." *Id.* at 643.

Or Lattin: "The management of the modern corporation is almost exclusively in the hands of the board of directors. Unusual powers such as those of amending the corporate assets, merger and consolidation, and dissolution belong to the shareholders." N. LATTIN, CORPORATIONS 211 (1959). *See also, e.g.*, I G. HORNSTEIN, CORPORATION LAW AND PRACTICE 446-47 (1959).

4. RESTATEMENT (SECOND) OF AGENCY § 118 (1958).

5. *See, e.g.*, Toledo Traction, Light & Power Co. v. Smith, 205 F. 643, 645-46 (N.D. Ohio 1913); Manice v. Powell, 201 N.Y. 194, 94 N.E. 634 (1911). This rule does not prevail in England; indeed, a leading English commentator found it to be "strange," and pointed out that if the board is staggered "one who has acquired a majority of the stock may have to wait, not merely until the next annual meeting but perhaps for several years before he can gain control of the board." Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1389 (1956). Two years after that comment was made, a Florida court held that a sole shareholder could not remove directors during their term. Frank v. Anthony, 107 So. 2d 136 (Fla. Dist. Ct. App. 1958).

The rule is one of common law. Statutory provisions in some states, including California, Ohio, and Pennsylvania, permit stockholders to remove directors without cause. *See* CAL. CORP. CODE § 810 (West 1955); OHIO GEN. CORP. LAW § 1701.58(C) (1964); PA. BUS. CORP. LAW § 1405(A) (1967). The Model Act makes such a provision optional. ABA MODEL BUS. CORP. ACT ANN. § 36A (1960). Also, directors can usually be removed without cause if the certificate or by-laws so provided at the time they took office. *See, e.g.*, Matter of Stylemaster Dept. Store, Inc., 7 Misc. 2d 207, 154 N.Y.S.2d 58 (Sup. Ct. 1956); Singer v. State Laundry Co., 189 Misc. 150, 70 N.Y.S.2d 550 (Sup. Ct.), *aff'd mem.*, 273 App. Div. 755, 75 N.Y.S.2d 514 (App. Div. 1947). However, it is unlikely that many corporations have certificates or by-laws with such provisions.

6. RESTATEMENT (SECOND) OF AGENCY § 385(1) (1958).

7. *See* note 22 *infra*.

legal model of the corporation sets up two power centers: ownership and management. How should decisionmaking power be allocated between the two?

The received legal model provides a starting point for inquiry into this question, but it does not do much more than that. For one thing, as a descriptive device this model is badly out of step with the corporate statutes, overemphasizing the shareholders' role in some respects, and underemphasizing it in others.⁸ For another, this model attempts to embrace all corporations, although it has come to be recognized that the corporate form is utilized by two types of business associations which may have little in common except their form: those owned by a relatively small number of persons (hereafter referred to as privately held corporations), and those owned by a relatively large number of persons (hereafter referred to as publicly held corporations). Finally, the model seems essentially descriptive rather than prescriptive in its nature, and is in any event insufficiently articulated to serve as a normative model.⁹ At best, then, it provides only a very general perspective from which the constitutional aspects of corporate law can be evaluated.

The purpose of this Article is to develop a prescriptive, or normative, model of decisionmaking—or rather, to develop two normative models, one for each of the two types of corporate enterprise—based on shareholder expectations and relevant considerations of public policy (Part I); and then to evaluate, in light of these models, the legal distribution of decisionmaking power between management and shareholders in making both the traditional¹⁰ and the modern¹¹ fundamental corporate changes (Part II). In the course of Part I we will critically reexamine the premises that have underlain discussion of the publicly held corporation during the last 30 or 40 years. In particular, it will be shown that stockholdings are much more highly concentrated, and shareholders much more likely to expect to participate in important corporate decisions, than is commonly assumed. In the course of Part II we will

8. See text accompanying notes 185-231 *infra*.

9. The term "normative" is ambiguous, since "norm" has both a prescriptive and a descriptive sense. Webster's 3d defines "norm" as follows: "1: an authoritative rule or standard . . . 2: a standard of conduct or ethical value: a principle of right action . . . an imperative statement asserting or denying that something ought to be done or has value . . . 3: an ideal standard binding upon the members of a group and serving to guide, control, or regulate proper and acceptable behavior . . . 4: average . . ." In this Article, the term "normative" is being used in its prescriptive sense.

10. See text at pages 60-68 *infra*.

11. See text at pages 71, 86-181 *infra*.

elaborate or develop several theories of statutory construction which are of particular relevance to corporate law, including the de facto and step transaction theories, and a theory of proprietary limitations on the powers of the board.

A. A Normative Model of Voting Rights in Privately Held Corporations

To get some perspective on the privately held corporation it is helpful to keep in mind the legal model of the partnership, the major alternative form of business association involving a relatively small number of owners. As regards decisionmaking, partnership law is essentially suppletory¹²—the major purpose of the relevant sections of the Uniform Partnership Act is to provide rules to govern those situations in which the partners have failed to provide their own, and thereby to implement the probable expectations of the parties involved. Such an approach would seem equally applicable to privately held corporations.¹³ Since the number of owners in such cases is, by hypothesis, relatively small, the law may normally assume that agreement between the owners are likely to be bargained out—to be real agreements, and not merely contracts of adhesion. Since such enterprises are seldom giant in size, the only principle of social policy which would seem applicable to their internal organization is the promotion of business efficiency, an objective best served by enabling the owners to arrange the organization of the enterprise as they choose, and to provide rules—based on the probable expectations of shareholders in such corporations—to govern decisionmaking where such arrangements have not been made.¹⁴

12. Cf. H. HART & A. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 35-36 (tent. ed. 1958).

13. There is a real need for such suppletory law in this area because typically shareholders in privately held corporations fail to deal with many important questions when they organize their corporation. Cf. Dykstra, *Molding the Utah Corporation: Survey and Commentary*, 7 UTAH L. REV. 1 (1960); Hayes, *Iowa Incorporation Practices—A Study*, (pts. 1-5) 39 IOWA L. REV. 409, 608, 40 IOWA L. REV. 157, 459, 588 (1954-1955).

14. Cf. Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 721-22 (1960).

The extent to which shareholders can by agreement vary the rules laid down by the traditional statutes as to internal corporate organization has been the subject of many cases and much literature. See, e.g., *Jackson v. Hooper*, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910); *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d 829 (1945); *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936); F. H. O'NEAL, 1 *CLOSE CORPORATIONS: LAW AND PRACTICE* 222-332 (1958). Although the law's original response was to prohibit such variation, the desirability of permitting shareholders in privately held corporations to make their own rules is now almost universally recognized by the commentators and is coming to be recognized by the courts, see *Arditi v. Dubitzky*, 354 F.2d 483 (2d Cir. 1965); *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1964); *Peck v. Horst*, 175 Kan. 479, 264 P.2d 888 (1953), *on rehearing*, 176

What are the probable expectations of such shareholders? Again, we may begin by looking to the partnership model. Four major aspects of this model are relevant:

- > (1) Absent contrary agreement, no person can become a member of a partnership without the consent of all the partners.¹⁵
- > (2) Absent contrary agreement, all partners have equal rights in the management and conduct of the partnership business.¹⁶
- > (3) Absent contrary agreement, differences among the partners "as to ordinary matters connected with the partnership business" are determined by a majority of the partners, but differences as to matters outside the scope of the partnership business, or as to matters which would be in conflict with the partnership agreement or "which would make it impossible to carry on the ordinary business of the partnership," require unanimous consent.¹⁷

Kan. 581, 272 P.2d 1061 (1954); *Leventhal v. Atlantic Fin. Corp.*, 316 Mass. 194, 55 N.E.2d 20 (1944); and the legislatures. *See, e.g.*, DEL. GEN. CORP. LAW §§ 351, 354 (1953); N.Y. BUS. CORP. LAW § 620 (McKinney's 1963).

Of course it is also important that persons who come in contact with corporations be dealt with fairly, and this objective may interact with questions of internal organization, but generally speaking the two problems are separable. For example, under partnership law the partners can arrange internal decisionmaking as they choose but, regardless of their internal arrangements, any partner has apparent authority to bind the partnership on a matter in the ordinary course of business unless the third party has knowledge that the particular partner has no authority in fact. *See* UNIFORM PARTNERSHIP ACT §§ 9(1), 18(h) (1949) [hereinafter cited as U.P.A.]. Similarly, it is arguable that limited liability should be restricted to cases where not all owners have a right to participate in management decisions, but the question under what circumstances an owner-manager should be permitted to limit his liability is separable from the question, should persons who use the corporate form be permitted to set up their own decisionmaking mechanisms.

15. *See* U.P.A. § 18(g). This Act has been adopted in most jurisdictions. *See* J. CRANE & A. BROMBERG, *PARTNERSHIP* 13, 15-16 (1968).

16. U.P.A. § 18(e).

17. U.P.A. § 18(h) provides that "[A]ny difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners." The dichotomy set up by this section is obviously incomplete: a decision which does not relate to "ordinary matters" may yet not be explicitly covered by the partnership agreement. However, U.P.A. § 9(3)(c) provides that "[o]ne or more but less than all the partners have no authority to:

Do any . . . act which would make it impossible to carry on the ordinary business of a partnership," and the received learning is that, as stated in the text, matters "outside the scope of the partnership business" require unanimous approval, whether or not explicitly covered by the agreement. *See, e.g.*, *Arado v. Keitel*, 353 Mo. 223, 229, 182 S.W.2d 176, 179 (1944) ("In case of diversity of opinion between the partners as to the partnership business and the conduct thereof, and . . . no stipulation in the partnership contract, the decision of a majority of the partners acting in good faith and within the scope of the partnership business binds the partnership."); J. BARRETT & E. SEAGO, 1 *PARTNERS AND PARTNERSHIPS: LAW AND TAXATION* 483-84 (1956) ("The powers of a majority of the partners are clearly limited to the ordinary

(4) Partnerships are normally for a term (usually a relatively short term),¹⁸ and dissolution is easy.¹⁹

Putting the term and dissolution provisions aside for the moment (since they do not ostensibly relate to decisionmaking), the decisionmaking elements of the partnership model might be adapted to the privately held corporation by giving all shareholders the right to participate in management, requiring differences of opinion on "ordinary matters connected with the . . . business" to be determined by a majority of the shareholders, and requiring unanimous consent for matters outside the scope of the business. Such a model would conform to the fair expectations of shareholders in many privately held corporations, who regard themselves as partners, and incorporate only to achieve tax savings, to limit liability, or the like, and not because they desire to organize on the corporate rather than the partnership model.²⁰ Indeed, shareholders in such corporations will often draw up elaborate agreements substituting partnership incidents (such as restrictions on the free transferability of shares, easy dissolution, and full participation by all shareholders in management) for normal corporate incidents, and must be bullied by their attorney into

operations of the firm. A majority of the partners could not cause the partnership to engage in a business different from the one in which such partnership was originally formed to engage."); J. CRANE & A. BROMBERG, *supra* note 15, at 304 ("Normally, the majority of the members of a partnership have the power to decide matters within the scope of the business, but they do not have the power to override the minority in the doing of an act which is outside the scope of the business they have agreed to carry on or which is in violation of a provision of the articles."); *id.* at 381-82 ("[T]he democratic principle of majority rule . . . extends only to ordinary matters connected with the partnership business, and not to matters which are extraordinary . . . or in violation of the partnership agreement; for these, unanimity is required."); J. CRANE & C. MAGRUDER, *CASES ON THE LAW OF PARTNERSHIP* 298-99 n.31 (2d ed. 1959) ("It seems clear that a majority of the partners cannot bind a dissenting partner by any act outside the scope of the firm business. . . ."); LINDLEY, *LAW OF PARTNERSHIP* 355-56 (E. Scamell ed. 1962) ("It has been over and over again decided that no majority, however large, can lawfully engage the partnership in matters outside the partnership business against the will of even one dissentient partner."). This formulation can be bottomed on several theories including fair expectations; the natural implications of § 9(3)(c), *cf.* *Fortugno v. Hudson Manure Co.*, 51 N.J. Super. 482, 498-99, 144 A.2d 207, 215-16 (1958); or the idea that important actions not explicitly permitted by the partnership agreement are implicitly prohibited. *Cf.* *Kentucky Distilleries & Warehouse Co. v. Louisville Pub. Warehouse Co.*, 19 F.2d 866, 867-68 (6th Cir. 1927).

18. *Cf.* J. CRANE & A. BROMBERG, *supra* note 15, at 1-2 n.1.

19. If the partnership is not for a specified term, any partner may cause dissolution at any time. U.P.A. § 31(1)(b). If the partnership is for a specified term, dissolution occurs at the end of the term, U.P.A. § 31(1)(a), or on the death of any partner, U.P.A. § 31(4), and may be caused by any partner even during the term, although in that case the dissolving partner will have acted wrongfully and will be liable to the remaining partners in damages. U.P.A. §§ 31(2), 38(2)(a)(11). These causes of dissolution are not exclusive; for additional causes, see U.P.A. §§ 31(1)(c), (d), (3), (5), (6).

20. *See, e.g.,* Kessler, *supra* note 14, at 717-18.

practicing the most elementary corporate courtesies, such as shareholder and director meetings.²¹ Nevertheless, such a model would not be suited to privately held corporations as a class, because it is based on the assumption that all owners are managers; and even in the case of privately held corporations it will frequently happen that by accident or design there are some shareholders who do not wish to be active in the management of the business. For example, shareholdings may have devolved upon widows or children, or the corporation may be owned by one or more families but managed by only a few family members or even by professional managers, or the corporation may have been organized by a group of individuals some of whom regard themselves as investors rather than managers.

What, then, are the expectations of the parties in such cases? This question might be reformulated as follows: Suppose a relatively small number of persons organize a business and agree with each other that several persons (including some but not all of the owners) will manage the business on a year-to-year contract, it being understood that the remaining owners have full-time interests outside this business. What matters would the owners expect the managers to decide, and what matters would the owners expect to decide by themselves? In answering this question the following factors seem particularly relevant:

(1) The extent to which the matter requires skills of a specifically business nature, as opposed to the more general enterprise-evaluation skills which might be called investment skills. The greater the need for specific business skills, the more likely the owners would expect the matter to be decided by the managers, since the managers would normally have such skills while the nonmanaging owners would not. On the other hand, the greater the need for investment skills, the more likely the owners would expect to make the decisions themselves since they would normally have such skills or have advisors who did.

(2) The economic significance of the matter, in terms of relative magnitude, relative risk, timespan of effect, and cost of reversal. The greater the economic significance of a matter, the more likely the owners would expect to decide it themselves.

(3) The frequency with which the type of matter arises. The more frequently a type of decision arises, the more likely the owners

21. *Id.* Following this idea, under the new Maryland close corporations law, MD. ANN. CODE art. 23, §§ 100-111 (Supp. 1968), where a corporation elects to be a "close corporation" its shares become transferable only if all the shareholders consent or a shareholders' agreement so provides, § 101(a); dissolution is easy, §§ 101(b), 109(a); and mergers and sales of substantially all assets requires unanimous approval, § 110.

would expect the managers to make it, partly because such decisions tend to become routine, and partly because of the inefficiency for both the enterprise and the owners in their individual capacities if frequent meetings of all the owners are required.

(4) The speed with which the type of matter must be decided. The more speed required, the more likely the owners would expect the managers to make the decision, since the managers are on the spot and can act quickly, while calling a meeting of all the owners would inevitably involve delay.

Based on these factors, and on an intuitive reading of probable shareholder expectations, we can construct a normative model of the privately held corporation by placing the kinds of decisions which arise in a business enterprise into four general categories, grouped under two broad headings: business decisions and structural decisions.

Business Decisions. The first category consists of decisions made in the ordinary course of business. Examples include decisions on hiring and firing, on the selection of suppliers, and on the price to be paid for materials. Characteristically, such decisions require specialized business skills, are not individually of great economic significance, affect a relatively short timespan, occur in profusion, and must be made very quickly. Requiring shareholder approval for such decisions would obviously be impossible. Where not all shareholders are managers, the enterprise could not function. Even permitting shareholders to participate in such decisions on an ad hoc basis would probably not reflect the expectations of the parties, since some shareholders will probably be participating in the enterprise on the assumption that such decisions would be made by management without shareholder interference.²² Such decisions should therefore be for management to make.

The second category consists of decisions which are not in the ordinary course of business but are nevertheless within the general framework of the business as it exists when the decision arises. Examples include decisions to substantially expand plant capacity, to enter into a contract for the sale of a significant portion of a firm's output, or to recognize a union. Unlike decisions in the ordinary course, such decisions characteristically involve fairly high stakes, affect a relatively long timespan, occur with a low degree of frequency

22. Cf. *Charlestown Boot & Shore Co. v. Dunsmore*, 60 N.H. 85 (1880); *Manice v. Powell*, 201 N.Y. 194, 94 N.E. 634 (1911); *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*, L.R. [1906] 2 Ch. 34, 94 L.T.R. 651; R. STEVENS, *HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS* 650-51 (2d ed. 1949); Aicken, *Division of Power Between Directors and General Meeting as a Matter of Law, and as a Matter of Fact or Policy*, 5 MELB. U.L. REV. 448 (1967) (reviewing the English cases).

(although, taken as a class, with some regularity), and need not be made on the spot (although time is normally a significant consideration). Like decisions in the ordinary course of business, however, such decisions characteristically require business rather than investment skills, and shareholder approval of such decisions should therefore not be required. It is less clear whether shareholders should be *permitted* to make such decisions on an ad hoc basis. The expectation of shareholders might very well be that while management could make such decisions without shareholder approval, a majority of the shareholders could either veto such an action (if the rights of third parties are not prejudiced) or direct that such an action be taken.²³ In the privately held corporation, therefore, such decisions should be for management, but subject to shareholder intervention on an ad hoc basis.

Structural Decisions. The third category consists of decisions which, although economic in character, are not made within the general framework or structure of the business as it then exists, but make a substantial change in that structure. Examples include a complete liquidation, a sale of substantially all assets, or a combination with another enterprise which significantly realigns ownership interests and significantly increases total size. Such decisions normally require what would usually be thought of as investment rather than purely business skills. For example, the skills involved in formulating a decision to merge with Corporation *B* or to

23. The principal area in which corporate law has recognized a distinction between business decisions in and out of the ordinary or usual course has been in connection with the authority of officers to bind the corporation in the absence of express board authorization. See *Lee v. Jenkins Bros.*, 268 F.2d 357, 365 (2d Cir.), *cert. denied*, 361 U.S. 913 (1959); Note, *Inherent Power as a Basis of a Corporate Officer's Authority to Contract*, 57 COLUM. L. REV. 868 (1957); *cf.* U.P.A. § 9(3)(e). On the issue of shareholder decisionmaking power, the little case-law that exists does not appear to recognize the distinction, suggesting instead that shareholders cannot make decisions as to any business matter, whether in or out of the ordinary course, *see* authorities cited in note 22, *supra*, and certainly the old rule should not prevail where the shareholders unanimously agree on the decision in question, *see* R. STEVENS, *supra* note 22, at 650-53, but it is uncertain how the issue would be resolved by a modern court in the case of a privately held corporation. Rule 14a-8 of the SEC's Proxy Rules (promulgated under the Securities Exchange Act of 1934) requires the inclusion of a shareholder proposal in the corporate proxy statement if, among other things, the proposal concerns a "proper subject for action by security holders" under the laws of the issuer's domicile, Rule 14a-8(c)(1), and does not consist "of a recommendation or request that the management take action with respect to a matter relating to the conduct of the ordinary business operations of the issuer." Rule 14a-8(c)(5), 17 C.F.R. § 240.14a-8(c)(5) (1968) (emphasis added). The precise meaning of "ordinary business operations" as used in 17 C.F.R. § 240.14a-8(c)(5)(1968) is disputable, *see* Crown Cork & Seal Co., SEC Minute (Feb. 28, 1964), printed in W. CARY, 1968 SUPPLEMENT TO R. BAKER & W. CARY, *supra* note 3, at 117, but in context the phrase seems to reflect the distinction drawn in the text between matters in and out of the ordinary course.

liquidate Corporation *B* are similar to the skills involved in formulating a decision to invest in Corporation *B*, and quite different from the skills needed to formulate an advertising campaign, conduct employee relations, or make steel. Management may or may not have the skill to make such decisions. On the other hand, shareholders in the privately held corporation (or, what is functionally the same thing, those upon whom they rely for investment advice) normally will have such skills, even though they may be unequipped to make ordinary or extraordinary business decisions. In other respects as well, such decisions are suitable for shareholders. Characteristically, they occur infrequently—in some cases no more than once in the life of an enterprise; they mature slowly—for example, decisions to merge or liquidate often involve many months of deliberation and seldom less than one or two; and they are of the greatest economic significance. It seems probable that the shareholders in a privately held corporation would regard such decisions as shareholder matters.

The fourth category consists of decisions relating to control of the enterprise. Examples would include changes in the ground rules of control (e.g., cumulative vs. straight voting, number of directors, information flow to shareholders), and election and removal of directors. Again it seems fairly clear that shareholders in a privately held corporation would expect that such decisions would be made by them, not by their managers.

In Part II these general categories will be fleshed out by applying them to specific cases. For now it should be observed that this normative model of the privately held corporation does not differ from the received legal model so much in principle as in its degree of articulation and in its emphasis on a structural test for differentiating shareholder and management matters, rather than a test based on whether the matter is “major,” “fundamental,” or “extraordinary.”

At this point, two further questions must be dealt with. First, given that structural decisions (as defined) are shareholder matters, what degree of approval should be required for such decisions? If structural decisions are equated with the kinds of decisions which partnership law categorizes as “outside the scope of the partnership business,” the partnership model would require unanimity. But this may not be desirable in the privately held corporation. Since partnerships tend to be for a relatively short term and are easily dissolved, the duration of a veto by one partner is limited. However, since corporations are normally perpetual and not easy to dissolve,²⁴ it

24. Unless the parties otherwise agree, voluntary dissolution of a corporation normally requires a majority or two-thirds vote, see text accompanying notes 216-17 *infra*, and

would seem unwise to permit any shareholder, no matter how small his interest, to veto a structural change.²⁵ The traditional statutes typically require two-thirds approval for many of the structural changes they cover.²⁶ This solution seems to be a fair one, subject to a satisfactory resolution of the appraisal rights problem discussed below.²⁷

The second question relates to whether management should have a formal legal role in structural changes. It is difficult to see why it should, at least in the privately held corporation. It has been suggested that such a role protects against "impetuous, ill-considered, and uncoordinated" actions.²⁸ This would seem excessively paternalistic in the context of the privately held corporation. A worthier possibility is that such a requirement protects minority shareholders against oppression by the majority, on the theory that management will act as disinterested fiduciaries, while majority shareholders may act out of purely selfish motives. But any attribution of disinterestedness to management is unrealistic in the case of structural changes, as will be shown below.²⁹ Furthermore, if this is the reason, it is apparent that the very purpose of the rule is to frustrate the wishes of the majority. Granted that this may be desirable when the majority threatens to act unfairly, it would seem preferable to protect the minority in other ways; in particular, by recognizing that when corporate decisions are made by shareholders the majority may stand in a fiduciary relationship to the minority, and that structural changes in which benefits do not flow equally to all shareholders, or in which majority shareholders are on both sides of a bargain, are therefore subject to judicial review for fairness.

Of course, in many privately held corporations managers and shareholders are identical. But a rule that shareholders in privately held corporations can make structural changes without management concurrence will not hinder the operations of such corporations, while

shareholders' agreements to vary the usual dissolution rules have met with mixed results. See Note, *Statutory Assistance for Closely-Held Corporations*, 71 HARV. L. REV. 1498, 1502 (1958). In contrast, any partner can dissolve a partnership at any time, and certain events, such as the death of a partner, automatically cause dissolution. See note 19 *supra*. Furthermore, generally speaking the liquidation of a partnership is less likely to result in tax liability than the liquidation of a corporation. See C. ROHRlich, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES* 256-65 (4th ed. 1967).

25. Cf. McNulty, *Corporations and the Intertemporal Conflict of Laws*, 55 CALIF. L. REV. 12, 28-29 (1967).

26. See text accompanying notes 185-219 *infra*.

27. See text accompanying notes 232-67 *infra*.

28. *Dyer v. SEC*, 289 F.2d 242, 245 (8th Cir. 1961).

29. See text accompanying notes 63-77 *infra*.

the contrary rule would tend to defeat legitimate shareholder expectations in the many other cases where shareholders and management are not identical, or where minority shareholders have disproportionately high voting power on the board because each director is entitled to one vote regardless of the number of shares he represents.

B. A Normative Model of Voting Rights in Publicly Held Corporations

1. Considerations of Public Policy

In formulating a normative model of decisionmaking in the privately held corporation, no consideration of public policy appeared applicable except the protection of fair expectations. Is this also true in the case of publicly held corporations? Many think not. In most economic subsectors a relatively small number of giant publicly held corporations have become so large, both in absolute size and in relation to their competitors, that they have freed themselves of scrvitude to the market and have become able authoritatively to determine, within broad limits, matters of such fundamental importance as the rate and direction of capital investment and technological innovation, and even price levels and degree of product differentiation.³⁰ Such economic power is not only significant in itself, but carries in its train a significant amount of power to control the social order. Some of those who are concerned with this state of affairs have advocated reform programs which include changes in the shareholders' role. Broadly speaking, these proposals fall into three schools.

(a) "Shareholder democracy."—One school consists of those who, sensitive to the dangers of concentrating great power in private hands, advocate the "republicanization" or "democratization"³¹ of the corporation, an important element of this program being increased

30. See, e.g., A.A. BERLE, *THE 20TH CENTURY CAPITALIST REVOLUTION* 9-60 (Harvest ed. 1954); A.A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 10-46 (1932); Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433, 439-42 (1962); Chayes, *The Modern Corporation and the Rule of Law*, in *THE CORPORATION IN MODERN SOCIETY* 25 (E. Mason ed. 1959); Kaysen, *The Corporation: How Much Power? What Scope?*, in E. Mason, *supra*, at 85; Mason, *Introduction*, in E. Mason, *supra*, at 1; Schwartz, *Institutional Size and Individual Liberty: Authoritarian Aspects of Business*, 55 NW. U.L. REV. 4 (1960).

31. See Latham, *The Body Politic of the Corporation*, in E. Mason, *supra* note 30, at 218; Latham, *Anthropomorphic Corporations, Elites, and Monopoly Power*, 1957 AM. ECON. REV. 303; Latham, *The Commonwealth of The Corporation*, 55 NW. U.L. REV. 25 (1960); cf. F. EMERSON & F. LATCHAM, *SHAREHOLDER DEMOCRACY* (1954).

shareholder power. Dean Bayless Manning has commented that this school "assumes what must be challenged—that the rest of society need not worry about corporations so long as the 'owners' are running them."³² This criticism seems apt, although if power to determine vital aspects of national economic life has become concentrated in the hands of a few enterprises, it might seem better to disperse decisionmaking within those enterprises so that such power does not become concentrated in the hands of a few individuals. Also, however unhealthy may be a de facto self-perpetuating oligarchy, it is only the shareholders' role that prevents something which seems even worse, that is, a de jure self-perpetuating oligarchy.³³ Nevertheless, it remains true that if the existence of giant enterprise conflicts with national economic and social goals, it is unlikely that this conflict will be resolved by increasing shareholder power, since shareholders *qua* shareholders are essentially interested not in national goals but in profits.

(b) *Client-group participation.*—Indeed, two other schools of thought appear to assume that shareholder power makes conflicts between giant enterprise and national goals more, rather than less, likely. But after starting with that shared premise, the two schools then diverge in their prescriptions. One school advocates giving a formal role in corporate decisionmaking to client-groups of the corporation other than shareholders—specifically, employees, suppliers, and customers (including distributors, dealers, and consumers)—at the expense of, or even to the exclusion of, the shareholders themselves. Professor Chayes says:

Of all those standing in relation to the large corporation, the shareholder is least subject to its power. . . . Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought. . . . Their interests are protected if financial information is made available, fraud

32. Manning, *Corporate Power and Individual Freedom: Some General Analysis and Particular Reservations*, 55 Nw. U.L. Rev. 38, 42 (1960); cf. Chayes, *supra* note 30, at 40.

33. A. A. Berle has said, "[W]henver there is a question of power there is a question of legitimacy. As things stand now, these instrumentalities of tremendous power have the slenderest claim of legitimacy. This is probably a transitory period. They must find some claim of legitimacy, which also means finding a field of responsibility and a field of accountability. Legitimacy, responsibility, and accountability are essential to any power system if it is to endure. They correspond to a deep human instinct. A man desires beyond anything else to have someone give him the accolade of 'Well done, thou good and faithful servant,' thereby risking the condemnation of 'You have been no good—get out.' If he has to say it to himself, or hear it from a string of people whom he himself has hired or controls, he is apt to die a cynical and embittered man." Berle, *Economic Power and the Free Society*, in *THE CORPORATION TAKE-OVER* 86, 98-99 (A. Hacker ed. 1965).

and over-reaching are prevented, and a market is maintained in which their shares may be sold. A priori, there is no reason for them to have any voice, direct or representational, in . . . prices, wages, and investment. They are no more affected than non-shareholder neighbors by these decisions. . . .

A concept of the corporation which draws the boundary of "membership" thus narrowly [i.e., restricts it to shareholders] is seriously inadequate . . . because the line between those who are "inside" and those who are "outside" the corporation is the line between those whom we recognize as entitled to a regularized share in its processes of decision and those who are not.

A more spacious conception of "membership," and one closer to the facts of corporate life, would include all those having a relation of sufficient intimacy with the corporation or subject to its power in a sufficiently specialized way. Their rightful share in decisions on the exercise of corporate power would be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power.

It is not always easy to identify such constituencies nor is it always clear what institutional forms are appropriate for recognizing their interests.³⁴

In evaluating the approach of this school, it is important to keep in mind that many client-groups have had some sort of institutionalized relationship with the corporation, but that these relationships have usually been built on the models of negotiation or litigation, rather than on the model of direct participation in decisionmaking through voting. In dealing with the interests of a given client-group it is therefore necessary to separate the questions (1) whether it is desirable to augment by law the client-group's power vis-a-vis the corporation, and (2) if so, how such power should be augmented—by increasing the client-group's power of negotiation (as under the National Labor Relations Act); by conferring upon it new substantive rights which can then be enforced, if necessary, through litigation or litigation-like processes (as under the Automobile Dealers' Day-In-Court Act or certain of the antitrust laws);³⁵ or by giving it direct voting participation in corporate decisions. Those who

34. Chayes, *supra* note 30, at 40-41; cf. R. LELLS, *THE GOVERNMENT OF CORPORATIONS* 79-85, 206 (1962); Dion, *Property and Authority in Business Enterprise*, 38 U. DET. L.J. 600 (1961); Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 239 (1962).

35. See, e.g., Clayton Act, §§ 4-5, 15 U.S.C. §§ 15-16 (1964); Automobile Dealers Day in Court Act, 15 U.S.C. §§ 1221-25 (1964). See generally S. MACAULEY, *LAW AND THE BALANCE OF POWER* (1966).

wish to augment the power of client-groups frequently fail to make clear whether they are merely suggesting that the traditional kinds of institutional relationships be strengthened or extended, or are advocating that the relationships between client-group and corporation move beyond the traditional models based on negotiation and litigation into a new model of direct participation. The latter approach is usually implicit, however, surfacing both in phrases such as "a regularized share in [the corporation's] processes of decision," and in the general tone of such proposals, which usually indicates that the author contemplates some radically new institutional relationship. But the failure to be explicit creates substantial problems in evaluation, because the idea of direct participation by client-groups, like eugenics, is grand in principle but susceptible of meaningful discussion only at the level of execution. If we postpone for a moment the position of labor and consider suppliers and customers, a number of difficulties immediately present themselves at that level:

(1) Suppliers and customers do not have the skills required to make corporate decisions—at least, not *qua* suppliers and customers. The skills needed to be a leather merchant are not necessarily those needed to decide the business or structural problems faced by shoe manufacturers, nor are such skills acquired with the purchase of one or more pairs of shoes.

(2) Lurking in the background of such proposals is the idea that all suppliers and customers are small. Of course, if that were true, giant corporations would be neither suppliers nor customers. Since they are both, the question must be answered, are *all* customers and purchasers to have a voice in corporate affairs, or only small ones? If the latter is the case, the proposal seems romantic to a fault. But if the former is the case, does that not mean that GM will have a vote in Greyhound, by virtue of being a supplier, and in U.S. Steel, by virtue of being a customer? If so, a disease worse than the cure is hard to imagine, since instead of limiting the power of giant corporations, this proposal would extend it even further and thoroughly cartelize American business in the process.

(3) Closely related to the last problem, there appears to be no feasible way, other than by dollar volume, to allocate votes among the members of such groups.

(4) The interests of suppliers and customers in large part conflict with those of the corporation. The primary objective, although not necessarily the sole objective, of a business corporation must be to turn a profit. If a corporation takes in less than it pays out, it must soon be liquidated. If it merely attains equilibrium it will not long

survive, because without profits or the prospect of profits neither internal nor external funds will be available when, as will inevitably occur, new funds are needed to adapt the corporation's business to changes in technology or the structure of the market. But suppliers and customers do not share this primary objective. Perhaps they recognize some vague long-range interest in assuring that the enterprise with which they deal survives, but this will seldom affect their short-range here-and-now calculations. If suppliers and customers are nevertheless to be given a voice in corporate decisionmaking, will it really be necessary to take a vote? How long does it take to figure out how leather dealers will vote on a shoe manufacturer's merger with a producer of Corfam? Is it not perfectly clear that such a dealer would apply one test to resolve every decision he is called upon to make: that is, whether the decision will result in larger or smaller purchases of leather from him at higher or lower prices; and that customers will apply a comparable test? Is there any possibility that this is desirable? Must we not conclude, with Beardsley Rumel, that

A scheme of representation of these interests [in the corporation] would be a travesty on democratic procedures. It would result in business political gangsterism that would destroy the efficiency of business management. It would inject, into circles requiring the most intimate confidence, individuals whose reliability was uncertain and whose motives and ambitions . . . would be injurious to the true welfare of [those] who have an interest in the success of the business.³⁶

If we turn now to labor, we see many of the same problems, although perhaps in less severe degree. There is the lack of skill—working in a shoe factory or being head of a machinist's union does not equip one to deal with decisions on either materials or mergers; there is the implicit and questionable³⁷ assumption that labor is invariably weak and the corporation invariably strong; there is the conflict of interest—although employees may have the survival of the enterprise somewhat more in mind than customers and suppliers, their short-run interests will often severely conflict with the long-run interests of the enterprise, as in the case of technological advance.

Labor can, however, be differentiated from suppliers and customers in at least one important way: There is readily at hand a principle for allocating labor's votes—one per employee. Indeed, in

36. Rumel, *Corporate Management as a Locus of Power*, 29 CHI.-KENT L. REV. 228, 242-43 (1951).

37. Cf. Winter, *Collective Bargaining and Competition: The Application of Antitrust Standards to Union Activity*, 73 YALE L.J. 14 (1963).

Germany labor has been given a formal role in corporate decision-making. German corporate law parcels out the functions performed by our board of directors between the supervisory board, a policy-making body, and the board of managers, an executive body.³⁸ Under the so-called codetermination principle German law provides for labor representation on the supervisory board of most large corporations and on the board of managers of large coal, iron and steel-producing corporations.³⁹ Clearly, then, labor participation in corporate decisionmaking is mechanically feasible. But granted its feasibility, is it desirable in the American context? After a study of codetermination and its applicability to American problems, Professor Vagts concluded that it was not:

One must first of all reckon with the fact that both American management and organized labor would oppose the move. . . .

. . . .
 . . . America has a long tradition of collective bargaining fostered by law which has admitted the unions to a voice in questions of policy and administration. Management must talk and bargain with union representatives about topics on which in Germany codetermination has the most effect In this way the unions have a voice in making decisions without the operational responsibilities that inhere in the German approach. This already highly developed institution could hardly exist side-by-side with codetermination. Most American commentators find a system in which management and labor bargain as representatives of conflicting interests less likely to produce pressures and conflicts within individual roles and see a major reconstruction of the labor relations structure on the German model as undesirable.

It should also be remembered that years of collective bargaining emphasis here have produced a union leadership very different from that of Germany. . . . It is doubtful that the collaboration involved in codetermination would run as smoothly in many American unions as it has in Germany. In short, codetermination is a complex institution. Its adoption involves a great deal more than having some labor representatives sitting on corporation boards of directors. It would involve a substantial rearrangement of our industrial relations picture, even assuming that it were considered desirable to enhance labor's power in this fashion.⁴⁰

38. Steefel & Von Falkenhausen, *The New German Stock Corporation Law*, 52 CORNELL L. REV. 518, 526-36 (1967); Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 50-53 (1966).

39. Steefel & Von Falkenhausen, *supra* note 38, at 537-39; Vagts, *supra* note 38, at 64-78. See generally W. BLUMENTHAL, *CODETERMINATION IN THE GERMAN STEEL INDUSTRY* (1956); H. SPIRO, *THE POLITICS OF GERMAN CODETERMINATION* (1958).

40. Vagts, *supra* note 38, at 76-78. Similarly, Blumenthal concluded: "It is clear that

On a more general level, it is open to serious question whether the idea of codetermination—direct voting participation by any client-group whether labor, suppliers, or customers—is not out of step with the fundamental nature of American institutions. Codetermination is a harmonizing and objectivizing principle; its basic premise is that persons with divergent objectives and training can work in tandem and make decisions in an objective way, even when self-interest may be involved. In contrast, American institutions are generally premised on the deliberate exploitation of divergence and conflict to achieve socially desirable ends.

It may be doubted whether the codetermination principle is congenial to the American temperament, and therefore whether it would work here even if mechanically feasible. In the American framework, at least, the interests of client-groups, and certainly the interests of the public, might be better protected by institutions which take account of the fact that the relationship between an enterprise and its client-groups encompasses both collaborative *and* conflicting purposes; in other words, by institutions modeled on the processes of negotiation and litigation.⁴¹

(c) *Managerialism*.—The first school of thought would achieve ends of social policy by increasing shareholder power, the second by reducing shareholder power and co-opting other constituencies into the corporate structure. The third school, sometimes known as the managerialists, would achieve ends of social policy by increasing management power, on the theory that while shareholders are interested only in profits, and client-groups only in their own welfare, management is in a position to balance the claims of all groups dependent on the corporation, including not only client-groups and shareholders, but the general public—in a position, that is, to run the corporation in the public interest.⁴²

codetermination is a peculiarly German phenomenon which developed only because of a particular historical and environmental setting. Perhaps it provided a means of overcoming the traditional intransigence of many German employers in their dealings with workers. In view of past history of resort to legislation rather than to free agreement in German labor relations, codetermination may have been a good means of accomplishing for German labor what American workers, for example, have long since achieved by other means. American labor has won similar benefits without having to shoulder the onerous responsibilities of company management. The strains and stresses which such a dual responsibility imposes on the union could not be contained in the United States as they were in Germany. Few American labor leaders could expect to be supported by their members under similar circumstances. Above all, the incentive to institute codetermination is lacking, for it accomplishes nothing that cannot be gained under free collective bargaining." W. BLUMENTHAL, *supra* note 39, at 114.

41. For examples of such institutions, see generally S. MACAULEY, *supra* note 35.

42. See, e.g., A. A. BERLE & G. MEANS, *supra* note 30, at 356; A. A. BERLE, *THE 20TH CENTURY CAPITALIST REVOLUTION* 61-115, 164-88 (Harvest ed. 1954); cf. Manning, *Corporate*

But the managerialists seem to greatly exaggerate the inclination and ability of management to serve as instruments of national policy. As Kaysen has observed:

It is not sufficient for the business leaders to announce that they are thinking hard and wrestling earnestly with their wide responsibilities Some of the more sophisticated accounts of the revolutionary transformation of business identify business as a "profession" in the honorific sense, and imply that professional standards can be relied on as a sufficient social control over the exercise of business power, as society does rely on them to control the exercise of the considerable powers of doctors and lawyers. This is a ramifying problem which we cannot here explore; it is sufficient to remark that there is, at least as yet, neither visible mechanism of uniform training to inculcate, nor visible organization to maintain and enforce, such standards; and, further, that even if business decisions in the business sphere could be "professionalized" and subject to the control of a guild apparatus, it seems less easy to expect that the same would be true of the exercise of business power in the social and political spheres.⁴³

Vide: automobile safety, cigarettes and health, industrial air and water pollution, redwoods, billboards, thalidomide, drug prices, and television.⁴⁴

However, even assuming the validity of managerialist theory, it is arguable that this theory does not necessarily require a redistribution of corporation decisionmaking power. While the managerialists, like the codeterminationists, tend to shy away from details at the level of execution, most do not appear to have in mind a redistribution of decisionmaking power. Rather, they contemplate a reconstruction of fiduciary ideology to emphasize the claims of client-groups, in order to insulate from attack management decisions favoring such groups.⁴⁵ In any event, most situations in which management must choose

Power and Individual Freedom, *supra* note 32, at 41. For a critical statement of this view, see Mason, *The Apogetics of "Managerialism"*, 31 J. Bus. 1 (1958).

43. Kaysen, *The Corporation: How Much Power? What Scope?*, *supra* note 30, at 104.

44. See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (use of inside information); J. A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 190-209 (Collier rev. ed. 1963) (executive compensation) (hereinafter cited as LIVINGSTON).

45. Actually, the managerialists seem to overestimate the extent to which traditional fiduciary ideology prohibits management from exercising a decent regard for the legitimate interests of those with whom the corporation deals. See *Scott v. Stanton Heights Corp.*, 388 Pa. 628, 131 A.2d 113 (1957); cf. Hayek, *The Corporation in a Democratic Society*, in *MANAGEMENT AND CORPORATIONS* 1985 at 99-100 (M. Anshien & G. Bach eds. 1960); Katz, *Responsibility and the Modern Corporation*, 3 J. LAW & ECON. 75, 78-79 (1960).

between higher profits and fair dealing with a given client-group involve business decisions—decisions on wages, prices, product quality, and the like—in which shareholders have no formal voice in any event, and managerialist theory might therefore be reconciled with the shareholders' role in decisionmaking by confining application of the theory to such decisions.

But one branch of managerialist theory has explicitly advanced from reconstruction of fiduciary ideology to redistribution of decisionmaking power. The views of this branch have been most forcefully articulated by Dean Manning in a well-known book review⁴⁶ of J. A. Livingston's *The American Stockholder*.⁴⁷ Livingston begins his book, and Manning his review, by exploring studies initiated by the New York Stock Exchange of the extent of popular stock ownership of publicly held corporations. These studies attempted to show the existence of a "people's capitalism" by establishing the existence of a relatively large number of individual shareholders (6,490,000 according to a 1952 study and 8,630,000 according to a 1956 study).⁴⁸ But buried between the lines, as Livingston shows and Manning develops, was the fact that shareholders tended to be members of the upper economic strata of the population.

Following this discussion, Livingston turns to shareholder rights, including "the right to throw . . . management out of the corporation by electing new directors."⁴⁹ He quotes approvingly a report of the Temporary National Economic Committee that "unless there is a powerful nucleus of some sort, it is practically impossible for the hundreds of thousands of scattered holders of a majority of stock of a giant corporation to get together even by proxy in order to exercise a degree of control,"⁵⁰ and concludes that "the ballot, as an instrument of control, is fictional."⁵¹

Mulling this over, Manning remarks:

In 1932, Berle and Means vivisected the modern corporation. They found a virtually omnipotent management and an impotent shareholdership. A quarter-century of unparalleled corporate law reform intervenes. In 1958, Livingston surveys the lot of the shareholder in a reformed world—a world of SEC regulation,

46. Manning, Book Review, 67 YALE L.J. 1477 (1958).

47. *Supra* note 44.

48. The most recent exchange estimate of individual shareholders is 24 million as of January 1, 1968. NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 40 (1968).

49. LIVINGSTON, *supra* note 44, at 35.

50. *Id.* at 37-38.

51. *Id.* at 38.

extensive disclosure requirements, elaborate proxy machinery, Stock Exchange self-discipline, corporate Good Citizenship, People's Capitalism and Corporate Democracy. His findings? A virtually omnipotent management and an impotent shareholdership.

.
 For the last generation, the prevailing school of thought among corporate reformers, writers and legislators has been that the key to ensuring managerial responsibility lies in the shareholder's power to vote. . . .

.
 Managements are almost never reprimanded or displaced by the shareholder electorate; shareholders remain stubbornly uninterested in exerting control. Management recommendations on mergers, option plans or other corporate matters are virtually never rejected by the shareholders. . . .

.
 [I]n the fever of the "democratic" proxy contest, the corporate patient is approaching the period of crisis. The modern proxy contest has become a grotesque travesty of an orderly machinery for corporation decision-making."⁵²

While many commentators have drawn from similar conclusions the lesson that more effective regulation of proxy machinery may be needed,⁵³ Manning raises the question whether the machinery should not be entirely scrapped:

. . . [T]he myth of shareholder democracy . . . [creates] an impression in the public mind . . . that a degree of shareholder supervision exists which in fact does not. It is quite arguable that the net effect of the corporate Jacksonians has been to impede their ultimate objective of responsible corporate management. The forms and mechanisms of shareholder democracy divert attention from the real problems of holding business managements to a desirable standard of responsibility. . . .

Altogether, the tenets of Corporate Democracy have served us little. . . . [L]ooking to the shareholder franchise for management supervision, we have been trying to design remedies for a make-believe world rather than a real one.⁵⁴

52. Manning, *supra* note 46, at 1485-88.

53. See, e.g., Bayne, Caplin, Emerson & Latcham, *Proxy Regulation and the Rule-Making Process: The 1954 Amendments*, 40 VA. L. REV. 387 (1954); Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage*, 39 VA. L. REV. 141 (1953); cf. Caplin, *Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Role*, 37 VA. L. REV. 653 (1951).

54. Manning, *supra* note 46, at 1489.

What troubles Manning, in other words, is that management is really responsible to no one, and in creating an appearance that management is responsible to the shareholders, the legal system is selling quack medicine, thereby diverting the patient, society, from seeking A M A advice.

The difficulty with this is that Manning never tells us exactly what ails the patient, other than a lack of managerial responsibility. In a companion article⁵⁵ Manning writes that, "without an infinitive, 'Power' is a bell without a clapper,"⁵⁶—meaning, in context, that it does not get us very far to talk about corporate power in general; rather we must ask what it is the corporation has power to do, and what, if anything, is wrong with that. But the same may be said about responsibility. It is hard to evaluate a suggestion that the present system has not kept managers responsible unless we are told exactly what it is management should be responsible for. The running of the corporation to generate maximum profits? The running of the corporation in the interest of specific client-groups? The running of the corporation explicitly "in the public interest"? Some blend of these? This is not made clear.

But whatever the sickness, Manning suggests a cure—a voteless model of the corporate structure:

Assume a large modern corporation similar to its typical commercial counterpart in all respects but two. First, the model abandons the *a priori* legal conclusion that the shareholders "own the corporation" and substitutes the more restricted conception that the only thing they "own" is their shares of stock. Second, the shareholder in this model corporation has no voting rights. His position would be quite similar to that of a voting trust certificate-holder with all economic rights in the deposited stock but no power to elect or replace the trustees by vote.⁵⁷

Pursuing his central theme of management responsibility, Manning asks: "In such a corporate world, how would one go about ensuring the desired degree of management responsibility while permitting corporate officers the necessary discretion to run the business?"⁵⁸ He finds his answer in a fourfold scheme, involving full and periodic

55. Manning, *Corporate Power and Individual Freedom*, *supra* note 32, at 41.

56. *Id.* at 45.

57. Manning, *supra* note 46, at 1490. See also A. A. BERLE, POWER WITHOUT PROPERTY 104-07 (Harvest ed. 1959); P. DRUCKER, THE NEW SOCIETY 333-43 (1950); Chayes, *supra* note 30, at 40-41; Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U. L.Q. 305, 329-30 (1937).

58. Manning, *supra* note 46, at 1490.

disclosure to shareholders and perhaps also to a judicial or other public agency; supervision of management in corporate matters affecting its own personal interest by some governmental or nongovernmental machinery; available avenues to the shareholders (presumably, a well-functioning market) for pulling out; and continuation or even extension of the business judgment rule⁵⁹ to ensure that management has the broadest discretion in business matters.

Since, generally speaking, shareholders in publicly held corporations are presently entitled to vote only on the kinds of matters we have called structural, the thrust of a voteless model is not to deal shareholders out of a formal role in business decisions—they were never dealt in—but to deal them out of a role in structural decisions. This is pretty severe.⁶⁰ In context, it is also a bit peculiar; having begun by rejecting the shareholder vote on the ground that it does not insure management responsibility, Manning ends up with a system in which management is responsible for absolutely nothing to absolutely no one. (The proposal to supervise self-dealing affects management responsibility only tangentially, and in any event judicial supervision of self-dealing is part of the present corporate system.) Indeed, Manning himself pretty quickly backs off from the suggestion that he is really offering the model as a prescriptive device:

The model is not to be taken literally of course. Legally votable stock is in fact votable, and the vote can, in some circumstances, make a difference

. . . .
 . . . [S]omeone has to select directors, and there would be no advantage in permitting them overtly to choose their own successors. Further, . . . improvement of disclosure requirements has been largely linked to shareholder voting. . . . Similarly, at least until a better solution can be found, the proxy fight will be difficult to dispense with, however much it may have gotten out of focus. . . .⁶¹

In light of this, why build the model at all? First, for the reason any corporate model is built—to test present law and proposals for law reform. But further, Manning suggests, “the model is useful because in the case of the large, publicly held modern corporation, it approximates reality.”⁶²

59. *Id.* at 1490-91.

60. See text accompanying notes 182-219 *infra*.

61. Manning, *supra* note 46, at 1493-94.

62. *Id.* at 1492.

Does it? Although the voteless model of the corporation is ultimately based on broad-gauged notions of social policy, it proceeds more immediately from two factual premises: The first is the explicit premise, just stated, that shareholders in publicly held corporations have no interest in or expectation of participating in structural decisions. The second premise is more or less implicit: That the managers of such corporations, if left to their own devices, would generally make structural decisions on the basis of considerations other than their own self-interest. Before confronting the former premise, it will be useful to examine the latter.

2. *Managerial Conflicts of Interest*

The premise that management will normally run corporate affairs without regard to its self-interest is probably accurate as to business decisions. Most such decisions do not give rise to a conflict of interest for management.⁶³ When they do (as where management causes the firm to purchase goods from a management-owned enterprise), the conflict is easily discernible, and the majority rule is that such transactions are voidable unless approved by a quorum and a voting majority of disinterested directors, and even then are voidable if unfair.⁶⁴ Proof of unfairness is always difficult,⁶⁵ but where the conflict concerns a business decision there is often a market which can be used as a standard, and usually the burden is on the interested manager to prove that the transaction was fair.⁶⁶ However, structural decisions, unlike business decisions, almost invariably give rise to conflicts of interest for management—conflicts for which judicial review is usually not feasible.

Such conflicts ultimately stem from the fact that while a shareholder's objective is that the corporation maximize its per-share earnings⁶⁷ (consistent, perhaps, with the doing of economic and social

63. This is not to say that a conflict of interest in such decisions is unknown. See, e.g., Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1, 14-15 (1956).

64. H. BALLANTINE, *supra* note 3, at 171-72.

65. See SEC. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. VII, at 555-56 (1938) [hereinafter cited as PROTECTIVE COMMITTEE REPORT].

66. H. BALLANTINE, *supra* note 3, at 175-76.

67. See R. A. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 315-16 (Calif. ed. 1961); Donaldson, *Financial Goals: Management vs. Stockholders*, HARV. BUS. REV., May-June 1963, at 116, 121; Hayek, *supra* note 45, at 111-112.

Of course, corporate earnings per share do not go directly into the shareholder's pocketbook, and it might therefore be more accurate to say that the shareholder's primary interest is dividend maximization and market-price appreciation, in a mix depending on the shareholder's financial circumstances. However, "[W]hile factors making for improvement in market price are many and their effects are rather obscure, it will be generally agreed that the

justice to client-groups), the maximization of per-share earnings is not the sole, and often not even the primary, objective of a manager.⁶⁸ For one thing, compensation received by managers in their capacity as employees is usually at least as significant as compensation received in their capacity as shareholders, and employee compensation is usually not directly tied to earnings.⁶⁹ More importantly, monetary compensation is only one, and perhaps the weakest, of the motives which shape a manager's conduct.⁷⁰ Among the most important of the nonfinancial motives are the desire for personal power and the desire for prestige.⁷¹ These motives bear heavily on structural changes, for they may lead management to engage in expansion (through combinations or otherwise) for its own sake, rather than for the sake of maximizing per-share earnings. In *Business Leadership in the Large Corporation* the economist R. A. Gordon described this phenomenon as follows:

One of the most important of the non-financial incentives offered by the large corporation is the opportunity to satisfy the urge for personal power. . . . [The executive's] power is a product of position rather than of personal wealth. Power in this case means authority over subordinates, control of the disposal of vast resources, and great influence over persons and affairs outside the firm. The corporation is the vehicle through which power comes to be held and exercised. . . .

Power thus secured increases with the size of the firm. Here lies an important explanation of the tendency of many large firms to become larger, even if sometimes the profitability of such expansion is open to serious question. The working of the power urge in this respect is reinforced by the tendency of businessmen to identify themselves with their enterprises. Expansion is desired for the

most central quantitative ratio by which anticipated change is measured is earnings per share The same is true for dividends since most dividend-paying companies tend to adjust payments according to some standard relationship to earnings." Donaldson, *supra* at 121. Furthermore, the factors other than earnings per share which affect market price are often not under the corporation's control. For example, if Corporations *A* and *B* have the same earnings per share, and *A* is in a glamour business, the market price of *A*'s stock will be higher; but what constitutes a glamour business at any one point in time is determined by traders' tastes, which are relatively unpredictable.

68. R.A. GORDON, *supra* note 67, at 312.

69. *Cf. id.* at x, 313, 334.

70. See J. BAKER, EXECUTIVE COMPENSATION PRACTICES OF RETAIL COMPANIES 1928-1937 1-2 (Harvard University Graduate School of Business Administration Business Research Study No. 23, 1939); C. BARNARD, THE FUNCTIONS OF THE EXECUTIVE 142-45 (1938); *cf.* Papandreou, *Some Basic Problems in the Theory of the Firm*, in 2 A SURVEY OF CONTEMPORARY ECONOMICS 183, 205-13 (B. F. Hayley ed. 1961).

71. J. BAKER, *supra* note 70, at 2; C. BARNARD, *supra* note 70, at 145-56; R. A. GORDON, *supra* note 67, at 305-07; PROTECTIVE COMMITTEE REPORT, *supra* note 65, pt. VII, at 11.

enhancement of personal power and also because of the satisfaction of being associated with a powerful organization.

. . . .

The large corporation can also offer prestige, over and above that which results from the executive's receipt of a large salary and bonus. Power itself brings prestige, as does the mere fact of heading a large and successful firm. As in the case of personal power, prestige is to some extent linked with the size of the firm, and too strong a desire for it may lead to overexpansion.⁷²

Furthermore, such proclivities may be strengthened by financial motives, since the management of an expanding firm may justify increased compensation on the ground of increased responsibility.

A second important set of nonfinancial motives is the managerial tendency to identify with the enterprise and the desire for security.⁷³ Just as desire for power and prestige may lead management to undertake expansion, so enterprise identification and a desire for security may lead management to oppose corporate contractions, liquidations, or even combinations with a larger enterprise, although the shareholders' financial interests might be best served by such an action. "[C]orporate managements seldom consider liquidation an alternative to unprofitable operations. The chief executive who has been long with his company rebels against the idea of 'his' firm's passing out of existence."⁷⁴ These proclivities too may be reinforced by financial considerations, since a liquidation, a contraction, or a combination with a larger firm may result in loss of the manager's job or reduction of his salary commensurate to a reduction in his responsibilities.⁷⁵

Conversely, management may recommend a combination with a larger enterprise or a disposition of assets to such an enterprise

72. R. A. GORDON, *supra* note 67, at 305-07. Also, management may tend to analyze a proposed combination primarily according to whether it will increase cash flow or increase total corporate earnings, and only secondarily according to whether it will increase earnings per share. A combination achieved through the issuance of stock may therefore be unduly favored by management, since it adds to cash inflow and total earnings without increasing cash outflow except for dividends paid on the newly issued stock. See Donaldson, *supra* note 67, at 120-23; cf. Hayek, *supra* note 45, at 111.

73. J. BAKER, *supra* note 70, at 2; R. A. GORDON, *supra* note 67, at 308-09, 310-11.

74. R. A. GORDON, *supra* note 67, at 308-10. See also H. SIMON, ADMINISTRATIVE BEHAVIOR 117-18 (2d ed. 1957); Papandreou, *supra* note 70, at 188.

75. Thus Graham and Dodd comment: "It is a trite but true remark that the determining factor in keeping an unprofitable business running is often the natural desire of the management to hold on to their jobs. Unfortunately, poor-caliber management is more anxious to hang on than high-caliber management, since the latter can usually find other and perhaps better employment elsewhere." B. GRAHAM & D. DODD, SECURITY ANALYSIS 608 (3d ed. 1951). See also PROTECTIVE COMMITTEE REPORT, *supra* note 65, pt. VII, at 11.

because of benefits which are promised to management in the way of employment contracts and the like. One commentator has gone so far as to say:

When we find [management] recommending [such] a change it is generally safe to assume that some side payment is occurring. . . . The most obvious kind of side payment to managers is a position within the new structure either paying a salary or making them privy to valuable market information. This arrangement, easily established with mergers, can look like normal business expediency, since the argument can always be made that the old management provides continuity and a link with past experience of the corporation.⁷⁶

In short, management is likely to be deeply self-interested in structural decisions, usually on a financial level, and almost invariably on a nonfinancial level. The latter is, if anything, more dangerous, partly because nonfinancial motivations are likely to be more intense, and partly because, far from perceiving the conflict of interest generated by such motives, management is likely to perceive its position as morally neutral or even morally admirable. That is, in the case of decisions which relate to the very structure of the firm, management is likely to view the shareholders as outsiders, selfishly interested only in profits, while it, management, is motivated by a greater good, the good of the firm.⁷⁷ All instinct teaches us the acute danger of such a fusion of self-interest and self-satisfaction.

How can these dangers be dealt with? Judicial review of conflicts of interest stemming from nonfinancial motives is virtually impossible. Even where a conflict of interest is partly financial, as where management jobs or salary levels are involved, the courts may be reluctant to apply the usual conflict-of-interest rules, such as the need for a disinterested quorum. This is illustrated by a case involving a privately held corporation, *Smith v. Good Music Station, Incorporated*.⁷⁸ There, RKO offered to purchase all of the stock of

76. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 118 (1965); see, e.g., "Some Officials Scorned for Personal Bargaining When Companies Join," Wall Street J., August 28, 1968, p. 1, col. 6; "Three Top Sheraton Officials to Benefit in Event of Merger," Wall Street J., January 31, 1968, p. 28, col. 4. In England, this is sometimes referred to as "the golden handshake."

77. See R.A. GORDON, *supra* note 67, at 308-11: "The executive not infrequently tends to look upon the stockholders as outsiders, whose complaints and demands for dividends are necessary evils, which must be reconciled with what is considered best from the point of view of the business itself as a continuing institution having an existence apart from that of its owners." *Id.* at 309; cf. J. BURNHAM, *THE MANAGERIAL REVOLUTION* 88-92, 192-93 (Midland ed. 1960); Baumhart, *How Ethical Are Businessmen?* HARV. BUS. REV., July-Aug. 1961, at 6, 10.

78. 36 Del. Ch. 262, 129 A.2d 242 (Ch. 1957).

GMS, which was owned by Smith, Rogers, and Underwood, for \$335,000 in cash, and to employ Rogers and his wife as consultants for five years at \$15,000 per year. This offer fell through, the price for the stock and the employment offer both being deemed insufficient. Subsequently, RKO offered to purchase all of GMS's assets at a higher price than it had offered for the stock, and also raised its offer to the Rogers individually. Meanwhile, another party made an offer to GMS which apparently was higher than RKO's, but which was conditioned on the reaching of an agreement on compensation for Rogers and the station manager. However, GMS's board, including Rogers, authorized the sale to RKO. Smith attacked the transaction on various grounds, including a lack of a disinterested quorum of directors. The court refused to apply the traditional self-interest rules on the ground that the conflict of interest was "remote." Furthermore, in effect if not literally, the court appeared to have put the burden on Smith to show unfairness, rather than on Rogers to show fairness. Such a burden would normally be all but impossible to shoulder in the case of a structural change because of the complexity of such transactions and the fact that a market standard is not normally available.

If judicial review on the complaint of dissatisfied shareholders is generally not feasible, because of the absence of a market standard and the difficulty of isolating the effect of a conflict of interest based on nonfinancial motivation, what other alternatives are available?

One alternative is to require disclosure of all material facts in connection with proposed structural changes, as under the SEC's proxy rules.⁷⁹ Even a naked requirement of disclosure is efficacious: Many men will not do publicly what they would do privately.⁸⁰ But disclosure without more has a disembodied quality, particularly if it is an after-the-fact, keeping-everyone-informed kind of disclosure.⁸¹ Therefore, even if disclosure is to be relied upon as a primary tool, it should be action-oriented disclosure, disclosure required in connection with an approval to be sought. And this seems true even if the approval will be granted more or less pro forma, simply because men have a different attitude when they must seek approval, even a pro forma approval, than when their only obligation is to let others know what they have already done or are thinking of doing.

79. See SEC Schedule 14A, Items 13, 14, 20, 17 C.F.R. § 240.14a-101 (1968). These sections are applicable only to structural changes requiring shareholder approval, and the proxy rules themselves are applicable only to corporations whose stock is listed on a national stock exchange or otherwise registered under § 12 of the Securities Exchange Act of 1934.

80. Cf. Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408 (1962).

81. Cf. *Laurenzano v. Einbender*, 264 F. Supp. 356, 361-62 (E.D.N.Y. 1966).

A second alternative, easily meshed with disclosure, is to require that decisions relating to structural changes be approved by a government agency, at least in the case of publicly held corporations. Such an approach, which has been partially adopted by California,⁸² has much to recommend it, but it has several limitations as a general solution. Although the California experience tends to establish the workability of such regulation, and its compatibility with the corporate institution,⁸³ the solution is nevertheless perceived as inefficient and not institutionally compatible,⁸⁴ and it is therefore unlikely to be adopted on a widespread basis unless a crisis situation develops. Indeed, California itself recently retrenched by exempting from such regulation, in its Corporate Securities Law of 1968, securities listed on the New York Stock Exchange.⁸⁵ A second limitation is that administrative regulation tends to take a reviewing rather than an initiating cast. Therefore, while such regulation can deal with structural changes that are proposed but not advisable, it normally cannot deal with structural changes that are advisable but not proposed.⁸⁶

A third alternative, which meets the two problems posed by administrative regulation and can be easily meshed with such regulation and with disclosure, is to put structural matters directly into the shareholders' province. This alternative, however, brings us to the second premise of the voteless model—that shareholders in

82. See CAL. CORP. CODE §§ 25017, 25120-22, 25140(a), (c), 25103 (West Supp. 1968). See also Dahlquist, *Regulation and Liability under the California Corporate Securities Act* (pts. 1-2), 33 CALIF. L. REV. 343, 349-53 (1945), 34 CALIF. L. REV. 344, 350-62 (1946); Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 213-18 (1958); Orschel, *Administrative Protection for Shareholders in California Recapitalizations*, 4 STAN. L. REV. 215 (1952); Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations*, 58 COLUM. L. REV. 1030, 1048-55 (1953). In theory, but apparently not in practice, other state blue sky laws also extend some degree of administrative regulation to certain structural changes. See Cowett, *Reorganizations, Consolidations, Mergers and Related Corporate Events Under the Blue-Sky Laws*, 13 BUS. LAW. 418, 760 (1958); Note, *supra*, at 1048 n.122. See also R. JENNINGS & H. MARSH, *SECURITIES REGULATION—CASES AND MATERIALS* 473 (2d ed. 1968); L. LOSS & E. COWITT, *BLUE SKY LAW* 36 n.99 (1958).

There is also a scattered amount of administrative regulation of structural changes, with the object of protecting shareholders, in the regulated industries. See Note, *supra*, at 1055-64.

83. See Jennings, *supra* note 82, at 214, 225-26; McNulty, *supra* note 25, at 42-43; Orschel, *supra* note 82; Note, *supra* note 82, at 1051-52, 1064-65 (1958).

84. Cf. L. LOSS & E. COWETT, *supra* note 82, at 327-29.

85. See CAL. CORP. CODE § 25100(o) (West Supp. 1968).

86. An analogous possibility to governmental review is review by an independent non-governmental institution. See, e.g., Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 306-09 (1954); Rostow, *To Whom and for What Ends is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY*, *supra* note 1, at 57-58, 70-71.

publicly held corporations have no interest in participating in corporate affairs at any level, so that such an approach would be of only theoretical import. As Manning puts it:

It is clear beyond question that shareholders as a lot have little or no real concern with . . . the "fundamental" transactions. . . . It is commonplace to observe that the modern shareholder is a kind of investor and does not think of himself as or act like an "owner." He hires his capital out to the managers and they run it for him; how they do it is their business, not his, and he always votes "yes" on the proxy.⁸⁷

Certainly this premise is a widely shared one.⁸⁸ But to what extent is it true?

3. Shareholder Expectations

(a) *The AT&T myth.*—In the absence of any hard data concerning the expectations of shareholders in publicly held corporations, the following assumption, which would probably find general acceptance, will be made: The extent to which a shareholder in such a corporation expects and wants to participate in structural decisions is intimately related to the size of his holdings. Therefore, one method of investigating the expectations of such shareholders is to explore the size of shareholdings in publicly held corporations.

In discussing shareholder expectations from this perspective, most commentators have taken as their model AT&T or GM.⁸⁹ In terms of number of record shareholders, at least, these corporations are not very typical. AT&T has over three million shareholders, and GM over 1.4 million.⁹⁰ In contrast, no other corporation seems to have more than 750,000 shareholders, and only eight others seem to have more than 250,000.⁹¹ However, the real question as to the typicality of AT&T and GM is not how many other corporations have a like number of shareholders, but how many others have a pattern of stock distribution such that the shareholders will not expect to participate in structural decisions.

Unfortunately, there are only a handful of studies relating to intracorporate stock distribution, and even these have generally

87. Manning, *supra* note 34, at 261.

88. See, e.g., Mason, *Introduction*, *THE CORPORATION IN MODERN SOCIETY*, *supra* note 1, at 2 ("The equity owner is joining the bond holder as a functionless *rentier*").

89. See, e.g., Chayes, *supra* note 30, at 25; Dion, *supra* note 34, at 611; Hornstein, *Corporate Control and Private Property Rules*, 92 U. PA. L. REV. 1, 3 (1943).

90. NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 27 (1968).

91. *Id.*

followed the pattern set by Berle and Means in *The Modern Corporation and Private Property*,⁹² and confined their attention to the 200 largest nonfinancial corporations.⁹³ The major exception is a recent study published in *Fortune* which examined the 500 largest industrials,⁹⁴ focusing principally on the issue of managerial control, and inquiring into intracorporate stock distribution only as a means to that end. Beyond the 200 largest nonfinancials, or the 500 largest industrials, the data is extremely sparse. There appear to be no studies on intracorporate stock distribution in the remaining corporations, or even on the distribution of the remaining corporations by number of shareholders. However, enough data does exist to justify the conclusion that corporations whose stock is so distributed that shareholders would not expect to participate in structural decisions are atypical.

We will develop the data by beginning with the largest corporations, and expand by examining concentric groups, ending with data on the total number of corporations.

(1) *The 200 largest nonfinancials.*—In their study of the 200 largest nonfinancial corporations in this country as of 1929 (measured by value of assets), Berle and Means found 65 cases in which no outstanding block of stock as large as five percent was held by a single shareholder or a compact group, and 16 more cases in which the largest outstanding block was in the five to twenty percent range.⁹⁵

92. A. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 47-118 (1932).

93. See R.A. GORDON, *supra* note 67, at 20-45; Larner, *Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963*, 56 AM. ECON. REV. 777 (1966); T.N.E.C., *THE DISTRIBUTION OF OWNERSHIP IN THE 200 LARGEST NON-FINANCIAL CORPORATIONS* (Monograph No. 29, 1940).

94. Sheehan, *Proprietors in the World of Big Business*, *FORTUNE*, June 15, 1967, at 178. See also Villarejo, *Stock Ownership and the Control of Corporations*, *NEW U. THOUGHT*, Autumn 1961, at 33, Winter 1962, at 47.

The T.N.E.C.'s Monograph No. 30 (1941) is entitled *SURVEY OF SHAREHOLDINGS IN 1,710 CORPORATIONS WITH SECURITIES LISTED ON A NATIONAL SECURITIES EXCHANGE*, but the scope of this study is quite limited: "Because of the magnitude of the task involved, no attempt has been made to parallel the analysis in the study of the 200 largest nonfinancial corporations [T.N.E.C. Monograph No. 29, *supra* note 93] of holdings of officers and directors . . . or the 20 largest record shareholders in each stock issue. Emphasis in this study . . . has been placed on stock ownership of the 1,710 corporations viewed for the most part as anonymous units. In consequence no reference is made to the extent of control by various specific groups over individual corporations . . ." *Id.* at xvii.

95. Twenty-two cases were found in which at least 50 percent of the stock was owned by a single shareholder or compact group; 73 in which 20-50 percent of the stock was so held; 21 in which the corporation was controlled through "a legal device" (that is, by shareholders possessing disproportionate voting power through pyramiding, voting trusts, or the like; and

In a study of the 200 largest nonfinancial corporations as of 1963, intended to bring the Berle and Means data up to date, Robert Lerner found 160 cases in which no block of stock as large as 10 percent was so held.⁹⁶ At least among the 200 largest nonfinancials, therefore, there is a marked trend toward increased dispersion of stock ownership. Lerner concluded that, "[the] evidence suggests that a firm may reach a size so great that, with a few exceptions, its control is beyond the financial means of any individual or group."⁹⁷ It may therefore be hypothesized that the reason for the trend toward increased dispersion of stock ownership among the 200 largest nonfinancials is that the degree of a corporation's stock dispersion tends to increase with an increase in the corporation's absolute size, at

three cases were found to be "special situations." A. A. BERLE AND G. MEANS, *supra* note 30, at 69-94, 116. Where a corporation was majority-owned by another corporation, the subsidiary was disregarded, that is, not included in the list of the 200 largest. *See id.* at 19 n.4.

96. Eleven cases were found in which 50 percent or more of the stock was held by a single shareholder or a compact group (including two corporations which Lerner classified as under "joint minority control" because each was controlled by two other corporations, neither of which owned a 50 percent interest, but whose aggregated interests amounted to more than 50 percent); and 29 cases were found in which 10-50 percent of the stock was so held (including one case which Lerner classified as under "joint minority control" because it was under the control of several shareholders, none of which apparently owned a 10 per cent interest but whose aggregated interests amounted to more than 10 per cent). Lerner, *supra* note 93, at 778-9, 783, and Appendix thereto. (The Appendix is unpublished, but is available from Mr. Lerner at the Department of Economics of Brandeis University.) Lerner followed Berle and Means in excluding from his list corporations which were majority-owned by another corporation, making an exception, however, where the parent corporation was itself not large enough to qualify for the list. *Id.* at 778 n.1.

Since Berle and Means and Lerner were primarily interested in management control rather than in the pattern of stock distribution, where a major block of stock in Corporation A was held by Corporation B, they inquired into the pattern of ownership of Corporation B to determine the "ultimate" type of control (as opposed to the "immediate" type of control) of Corporation A. For our purposes "immediate control" is more significant, since we are concerned with the expectations of large shareholders, and in the case just described Corporation B is a large shareholder in Corporation A, regardless of how B is itself controlled. In any event, neither the Berle and Means or Lerner figures, nor the trend from 1929 to 1963, are significantly different when the figures for "ultimate" rather than "immediate" control are examined.

97. Lerner, *supra* note 93, at 786. The evidence referred to is that in 1963 "the proportion of the 200 largest nonfinancial corporations that were management-controlled [i.e., in which there was no block as large as 10 percent] . . . was about the same as the proportion of assets so controlled, while in 1929 the proportion of assets that were management-controlled was a good deal larger than the proportion of companies so controlled." This indicates, Lerner feels, "That management control, which was concentrated among the larger firms on the 1929 list, has since reached down to relatively smaller (though absolutely larger) firms . . . and has become rather evenly distributed among the '200 largest.'" *Id.* at 785. Thus in 1929, more than 50 percent of the 200 largest nonfinancials which were management-controlled were among the 80 largest, and only 11 percent were among the 40 smallest, while in 1963 the distribution of management-controlled firms among the 200 largest nonfinancials was more or less even. *See id.*, table 3 at 786. The growth of conglomerate corporations, which tend to swallow smaller corporations, may therefore be expected to increase dispersion of stock ownership.

least among corporations of very large size,⁹⁸ and that as the absolute size of all corporations increases, the degree of stock dispersion in the relatively largest firms will tend to increase correspondingly. A corollary of this hypothesis is that as we go down the ladder of firms ranked by relative size, the degree of stock dispersion should decrease.

(2) *The 520 largest industrials.*—In 1967, a *Fortune* study analyzed the 500 largest industrials listed in the 1967 *Fortune Directory*. (This is a narrower class than nonfinancials, since as defined by *Fortune* it excludes transportation, utility, and merchandising companies.)⁹⁹ *Fortune* found that in approximately 150 of these corporations a single individual or members of a single family held 10 percent or more of the stock. The *Fortune Directory* includes only corporations which publish certified statements of their financial results, and in 1966 *Fortune* estimated that approximately 20 designated privately owned corporations would have been included in the *Directory* if they published such results.¹⁰⁰ Including these 20 corporations, at least 170, or approximately one-third, of the 520 largest industrials, have blocks of at least 10 percent outstanding; undoubtedly, this percentage would be much higher if 10 percent blocks owned by groups of business associates or by other corporations had been included. This 33 percent figure is not only significant in itself, but also tends to confirm the hypothesis

98. See Sheehan, *supra* note 94, at 180; cf. REPORT OF THE SPECIAL STUDY OF SECURITIES MARKET OF S.I.C. pt. 3, H. DOC. NO. 95, 88th CONG., 1st Sess., at 26, 29 (1963) (hereinafter cited as SPECIAL STUDY, pt. 3). But see T.N.E.C., Monograph No. 30, *supra* note 94, at 54. This monograph found a very high degree of concentration of stock ownership among 1710 corporations with securities listed on a national stock exchange as of 1937, and concluded that it was "doubtful whether any significant relationship exists between size and degree of concentration" among the corporations studied. *Id.* However, the BERLI & MEANS data indicate a high degree of concentration even among the 200 largest nonfinancials as of 1929, so it may be that at that time even the largest firms were not large enough to precipitate a scattering effect. Also, the monograph uses the term "concentration" in a slightly different sense than we are using the term "dispersion." For purposes of this Article, dispersion is a function of the size of the largest outstanding blocks, and stock is highly dispersed when few or no shareholdings are large enough in size to lead their owner to expect to participate in and be interested in structural changes. For purposes of the monograph, concentration was a function of the percentage of stock held by given percentages of shareholders. *Id.* at 48 & n.3. Thus the monograph viewed stock ownership as concentrated when a small percentage of shareholders owned a large percentage of the total number of shares, even though the largest blocks were very small. If a corporation had 100,000 shareholders, one percent of whom owned 50 percent of its stock, the stock ownership of the corporation would be considered highly concentrated for purposes of the monograph, even though no one shareholder happened to own more than one-tenth of one percent of the stock, so that the stock would be considered highly dispersed for purposes of this Article.

99. See Seligman, *The Editor's Desk*, FORTUNE, June 15, 1967, at 161.

100. Sheehan, *There's Plenty of Privacy Left in Private Enterprise*, FORTUNE, July 15, 1966, at 224.

that the degree of stock dispersion is related to absolute size, since only 20 percent of the 200 largest nonfinancials had similar blocks outstanding.¹⁰¹

Having just about exhausted the readily available information on intracorporate stock distribution, we must now turn to data on the distribution of corporations by number of shareholders.

(3) *Corporations listed on the national stock exchanges.*—One indirect source of information on the distribution of corporations by number of shareholders is the number of listings on the New York and American Stock Exchanges, since both of these exchanges have established minimum criteria for the original listing of stock, including a minimum number of shareholders, and lower criteria which trigger delisting. For original listing, the New York Stock exchange normally requires at least 2000 shareholders and publicly held shares with an aggregate market value of at least 14 million dollars.¹⁰² Delisting is considered if the number of shareholders falls below 1000 or the aggregate market value of publicly held shares falls below four million dollars.¹⁰³ The American Stock Exchange normally requires for original listing at least 900 public shareholders and aggregate market value of publicly held shares of at least two million dollars.¹⁰⁴ Delisting is considered if the number of shareholders falls

101. The population studied, and the methodology used by *Fortune* and Larner are not strictly comparable, but the differences probably tend to offset each other. *Fortune* studied the 500 largest industrials, while Larner studied the 200 largest nonfinancials, only 117 of which were industrials. Of these 117 industries, a 10 percent or more block appears to have been outstanding in 28 or 29, or about 25 percent. See Larner, *supra* note 93, at 783 and Appendix. On the other hand, Larner included 10 percent blocks owned by an individual, a family, a group of business associates, or (provided the block was less than 50 percent) another corporation, while *Fortune* included only 10 percent blocks owned by an individual or a family. *Fortune* would undoubtedly have found a larger number of corporations with 10 percent blocks outstanding if, like Larner, it had included blocks held by a group of business associates or by another corporation.

102. NEW YORK STOCK EXCHANGE, COMPANY MANUAL at B-3 (1968). Other minimum criteria include 1800 round-lot shareholders; tangible net assets of \$14 million; pre-federal tax profits of 2.5 million dollars in the latest fiscal year and two million dollars in each of two preceding years; one million shares outstanding; and 800,000 publicly held shares (that is, shares held other than by insiders). *Id.*

103. *Id.* at A-292. Delisting is also considered if the number of round-lot holders falls below 900; or if the aggregate market value of shares outstanding, or the net tangible assets available to common stock, falls below 7 million dollars and the average net income for the past three years falls below 600,000 dollars; or if the number of publicly held shares falls below 400,000. *Id.*

104. CCH, 1960 AMERICAN STOCK EXCHANGE GUIDE: ¶ 10,001 at 8903-04. Other minimum criteria include 600 round-lot shareholders; net tangible assets of at least 3 million dollars; pre-federal tax profits in the last preceding fiscal year of 500,000 dollars, and net income of 300,000 dollars; 300,000 publicly held shares; and a price per share of at least five dollars for a reasonable time prior to filing of the listing application. *Id.*

below 450, or the aggregate market value of publicly held shares falls below 750,000 dollars.¹⁰⁵

Because of the many advantages which accrue from listing on these exchanges, such as highly increased marketability of stock and ease of establishing market value for purposes such as determining estate tax or borrowing,¹⁰⁶ a corporation which can list on one of these exchanges will normally do so. It can be safely assumed, therefore, that at a minimum the number of corporations with common stock listed on both exchanges should approximate the total number of nonfinancials¹⁰⁷ which exceed the American Stock Exchange's delisting criteria. It is probably safe to assume further that most corporations with common stock traded on these exchanges exceed not only the minimum delisting requirements, but the requirements for original listing,¹⁰⁸ and also that because of the greater prestige of a New York Stock Exchange listing a corporation which can list on the exchange will usually do so. Given these assumptions, the total number of corporations with common stock listed on the New York Stock Exchange should approximate the total number of nonfinancials which meet that exchange's minimum requirements for original listing, and the total number of corporations with common stock traded on the American Stock Exchange should approximate the total number of corporations meeting its minimum requirements for original listing, but falling below those of the New York Stock Exchange.

As of 1968 the common stock of approximately 1250 corporations was traded on the New York Stock Exchange,¹⁰⁹ and the common

105. *Id.* ¶ 10.051 at 8977-78. Delisting is also considered if the number of round-lot shareholders falls below 300, the number of publicly held shares falls below 150,000, or the corporation has not been operating at a profit. *Id.*

106. *See generally* NEW YORK STOCK EXCHANGE, A LISTING ON THE NEW YORK STOCK EXCHANGE (1961).

107. Big banks have only recently begun to list (as of September 1968 only one major bank and three bank holding companies were listed on the New York Stock Exchange, *see* Metz, *Making Markets in Bank Stocks*, N.Y. Times, Sept. 10, 1968, at 60, col. 7), and many important life insurance companies do not list because they are mutual, that is, owned by policyholders rather than by shareholders.

108. The New York Stock Exchange does not keep comprehensive figures on all listing characteristics of its listed stock. It does, however, keep figures on the number of outstanding shares. On June 30, 1968, almost all listed issuers of common stock met the minimum requirements for original listing for this factor. Letter from Thomas T. Murphy, Research Associate, New York Stock Exchange, to the author, September 25, 1968 (on file with the *California Law Review*). Similarly, the booklet *Common Stocks Listed on the New York Stock Exchange* (1967), issued by the Exchange, indicates that only a handful of listed corporations would fail to meet original listing standards regarding value of shares. *See id.* at 22-39.

109. *See* SEC, 34th ANNUAL REPORT 68 (1969); Letter from Robert L. Dratwa, Research Associate, New York Stock Exchange, to the author, Aug. 23, 1968 (on file with the *California Law Review*).

stock of approximately 1000 corporations was traded on the American.¹¹⁰ Assuming that approximately 100 additional nonfinancials are eligible for listing on the New York Stock Exchange and about 250 additional would be eligible for the American, it seems probable that there are approximately 2600 nonfinancials in the United States with at least 900 shareholders and publicly held shares with an aggregate market value of two million dollars, and that approximately 1350 of these have more than 2000 shareholders and publicly held shares with an aggregate market value of 14 million dollars.

(4) *Corporations listed on the regional stock exchanges.*—In addition to the New York and the American Stock Exchanges, there are a number of major regional exchanges, such as the Boston, the Midwest, the Philadelphia-Baltimore-Washington, and the Pacific Coast. The listing requirements of these exchanges vary considerably. Thus the Pacific Coast Stock Exchange normally requires, among other things, at least 750 shareholders,¹¹¹ while the rules of the Philadelphia-Baltimore-Washington Exchange merely provide that its committee on stock list “shall receive and consider all applications for the listing of securities.”¹¹² It seems likely that most corporations with common stock traded exclusively on a major regional exchange would be relatively large, but would not meet the requirements for original listing on the American Stock Exchange. At the end of 1967, the number of corporations with common stock traded exclusively on a major regional exchange was approximately 250.¹¹³

(5) *Corporations whose stock is registered under section 12(g).*—Section 12(g) of the Securities Exchange Act requires the registration of any class of stock held by 500 or more record shareholders and issued by a corporation with over one million dollars in assets, unless the stock is listed on a major exchange (and is therefore registered under section 12(b) of the Act) or the corporation is exempt

110. See SEC, 34th ANNUAL REPORT 68 (1969); Letter from F. James Koch, Director, News Bureau, American Stock Exchange, to the author, Sept. 6, 1968 (on file with the *California Law Review*).

111. CCH, 1967 PACIFIC COAST STOCK EXCHANGE GUIDE ¶ 3025, at 3053.

112. CCH, 1965 PHILADELPHIA-BOSTON-WASHINGTON STOCK EXCHANGE GUIDE ¶ 2801, at 2301.

113. SEC, 34th ANNUAL REPORT 57-58 (1969). Actually, this report gives the number of common stock issues traded on such exchanges, rather than the number of issuers of such common. The latter may be slightly smaller than the former, since one issuer may have more than one class of common publicly traded, but it is unlikely that there are more than a few such cases. Also, the report is in terms of stocks traded, rather than stocks listed. A handful of issues are admitted to trading on a major regional exchange, most of them on the Honolulu Exchange, even though unlisted on any exchange. See *id.* at 72-73, 187.

(the major exemptions cover certain types of financial and nonprofit institutions). As of June 30, 1968, the total number of corporations with stock registered under section 12(g), but with no stock traded on a major exchange, was approximately 2700.¹¹⁴ If we assume that most listed stock also meets the requirements of section 12(g), the total number of nonfinancial corporations with over 500 shareholders and one million dollars in assets would be approximately 5200.

(6) *Total number of publicly held corporations.*—The New York Stock Exchange runs periodic censuses of share ownership in publicly held corporations, which it defines as corporations whose stock is held by at least 300 shareholders and traded on a national exchange or over-the-counter. The Exchange estimates that there are approximately 7500 such corporations.¹¹⁵

(7) *Total number of corporations.*—The Internal Revenue Service issues annual statistics on the total number of corporations filing tax returns. According to the figures covering corporations with accounting periods ending between July 1965 and June 1966, the total number of active corporations filing returns was 1,427,606.¹¹⁶ Of these, approximately 100,000 were financials.¹¹⁷ The number of wholly-owned subsidiaries cannot be determined from the figures, but does not exceed 175,000, and is probably substantially less.¹¹⁸ In round numbers, therefore, the total number of active corporations other than financial institutions and wholly-owned subsidiaries is approximately 1,200,000.

(8) *Distribution of all corporations by number of shareholders.*—There is almost no data on the distribution of these 1,200,000 corporations by number of shareholders. At one end of the scale, we know that approximately 7500 have 300 or more shareholders. At the other end, we know that at least 174,000 had 10 or less shareholders, because that many corporations elected special tax treatment (essentially, partnership treatment) under Subchapter S of the Internal Revenue Code,¹¹⁹ and a corporation cannot qualify under Subchapter S if it has more than 10 shareholders. But

114. See *id.* at 36-37; SEC. 33d ANNUAL REPORT 10 (1968).

115. See NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 24.

116. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1965 CORPORATION INCOME TAX RETURNS, table A, at 2 (Preliminary, 1967).

117. See *id.*, table 1, at 17-18.

118. See *id.* table C, at 2.

119. *Id.* at 1.

undoubtedly there were a great many more corporations with 10 or less shareholders which did not elect to be taxed under Subchapter S because they were otherwise ineligible or preferred normal corporate tax treatment.

Nevertheless, it seems likely that a substantial number of corporations are in the 10-300 shareholder range. For one thing, some minimum degree of continuity in the distribution curve is to be expected. For another, a significant proportion of the total number of corporations are of a large absolute size in terms of assets: Over 800,000 have at least 50,000 dollars in assets, over 575,000 have at least 100,000 dollars in assets, over 290,000 have at least 250,000 dollars in assets, over 150,000 have at least 500,000 dollars in assets, and over 85,000 have at least one million dollars in assets.¹²⁰ If the hypothesis that dispersion is related to absolute size is correct, many of these corporations could be expected to have more than 10 shareholders. Another relevant factor is the increasing importance of the service sector of the economy and the lifting of restraints imposed by tradition or law on the incorporation of certain kinds of service firms, such as professional firms, brokerage houses, and advertising agencies. Many firms in the service sector are of considerable size, but the nature of the sector is such that few are likely to grow to giant size,¹²¹ and a substantial number might therefore be expected to fall in the 10-300 shareholder range. Finally, the New York Stock Exchange estimates that there are 40,000 corporations with shares quoted more or less actively over the counter,¹²² and it seems probable that the great bulk of these corporations have at least 100 shareholders. Eliminating from this total the 5000 or so corporations which are not listed but have more than 300 shareholders,¹²³ leaves at least 35,000 corporations in the 10-300 shareholder range.

What conclusions can be drawn from these figures? First, they show just how atypical AT&T is. Indeed from a lawmaking point of view, even the publicly held corporation might be regarded as atypical. If, with the New York Stock Exchange, we draw the line between publicly and privately held corporations at 300 shareholders, the data shows approximately 1.2 million privately held nonfinancial corporations, as against only 7500 publicly held. Thus to the extent

120. *Id.* table 2, at 19. These totals include financials, which are aggregated in the preliminary figures with real estate corporations and certain types of service corporations. *See also* SPECIAL STUDY, pt. 3, *supra* note 98, at 19-20 and Chart IX-a.

121. *See* V. FUCHS, *THE SERVICE ECONOMY* 1-5, 9-11, 190-92 (1968); Kaysen, *The Social Significance of the Modern Corporation*, 47 *AM. ECON. REV.* 311, 313 (1957).

122. *NEW YORK STOCK EXCHANGE*, 1968 *FACT BOOK* 24 (1968).

123. *See* text accompanying notes 102-115 *supra*.

that corporate law is cut to the model of the publicly held corporation, it will fit in only a small fraction of the total cases. It might be argued that such a result is nevertheless acceptable considering the enormous economic significance of publicly held corporations. However, this argument seems unsound: If shareholders in such corporations are not interested in voting on structural changes and always vote "yes," to require voting on publicly held corporations is at worst a minor nuisance, while to dispense with it in the other 1.2 million corporations is to defeat important and legitimate expectations.

There is, of course, a way of avoiding this problem—to separate out publicly held corporations for special statutory treatment. To evaluate that possibility it is necessary to come directly to grips with the question whether, as is commonly assumed, shareholders in such corporations have no expectation of participating in structural changes. On examination, it appears that this assumption is not solidly based in fact.

First, it must be recalled that of the 7500 publicly held nonfinancials, approximately 6000 probably do not meet the listing requirements of the New York Stock Exchange, that is, have less than 2000 shareholders, 14 million dollars in net tangible assets, and average annual profits of two to three million dollars. In terms of shareholder expectations, such corporations are much more likely to resemble privately held corporations than giants like AT&T. As Professor Vagts has commented:

[T]here is a class of corporations in between these extremes [of the giant and closely-held corporation] still fairly closely resembling the model for which most corporations laws were intended. . . . Internally they have a number of stockholders too great to permit their shareholders to run the firm themselves but not too great to prevent them from keeping in touch with its activities and rallying to correct management when it strays too far from their view of things. It is in this stratum of firms with perhaps 100 to a few thousand shareholders that the bulk of proxy contests take place and that insurgents have some hope of success. A shift in corporate legal structure appropriate enough for the corporate giant might be burdensome or even disastrous for the intermediate concern as well as for the midget.¹²⁴

Second, the pattern of stock distribution even in many of the

124. Vagts, *supra* note 38, at 32; cf. Folk, *Recent Developments in Corporation Statutes*, 20 J. LEGAL ED. 511, 519 (1968).

1250 corporations with common stock listed on the New York Stock Exchange appears to be such that shareholders would legitimately expect to participate in structural decisions. It seems fair to assume that a 10 percent stockholding would give rise to such an expectation. But the *Fortune* study shows that at least one-third of the 520 largest industrials have at least 10 percent blocks outstanding, and this proportion probably increases rapidly with decreases in absolute size. Furthermore even a 10 percent figure is too high for purposes of measuring shareholder expectation. The 10 percent figure is commonly used as the size of shareholding that gives *control* of publicly held corporations.¹²⁵ Although it may be too low for that purpose, it seems much higher than the minimum size shareholding which would give rise to an interest in structural decisions.¹²⁶ At least in the publicly held corporation, a figure of one percent would seem more appropriate; the Wharton School's *Study of Mutual Funds*, conducted under the SEC's auspices, considered that control significance attached to such blocks.¹²⁷ In fact, it seems likely that even a block smaller than one percent would give rise to such an expectation if it was of a large absolute (dollar) size or if it was held by a professional investor. But we need not go that far, because it appears that the presence of a large number of significant stockholdings is a common phenomenon even in the very largest of corporations. The strongest evidence for this is the findings resulting from a comprehensive survey conducted by the SEC Special Study of over-the-counter corporations in which the broker-dealer community had shown interest during the last three months of 1961. This survey showed that in about half or more of each category of sampled corporations with less than 1000 shareholders (1-24, 25-99, 100-199, 200-299, 300-499, 500-799, and 750-999), the ten largest record shareholders held 50 percent or more of the stock; in more than half of the sampled corporations with 1000-1999 shareholders, the ten largest record shareholders held at least 40 percent of the stock; in about half or more of the sampled corporations with 2000-2999 or 3000-4999 shareholders, the ten largest record shareholders held at least 30 percent of the stock; in almost 30 percent of the sampled corporations with 5000 shareholders, the ten largest record shareholders held over

125. Cf. Lerner, *supra* note 93, at 779; Sheehan, *supra* note 94. See generally Enstam & Kamen, *Control and the Institutional Investor*, 22 *BUS L.* 289, 315 (1968).

126. SEC. PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H. R. REP. NO. 2337, 89th Cong., 2d Sess. 308 (1966) [hereinafter cited as SEC MUTUAL FUND STUDY].

127. WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H. R. REP. NO. 2274, 87th Cong., 2d Sess. 26,412, n.19 (1962) [hereinafter cited as WHARTON STUDY]. See also SEC MUTUAL FUND STUDY 308.

30 percent of the stock; and in about 40 percent of such corporations the ten largest record shareholders held almost 20 percent of the stock.^{12x}

Our conclusion, then, is that the AT&T model is atypical: The pattern of stock distribution in the overwhelming majority of corporations, even publicly held corporations, is such that many shareholders will be legitimately interested and expect to participate in structural decisions.

(b) The fallacy of "the average shareholder"

(i) The proprietary principle of corporate law.—It is widely assumed that the average shareholder—or, to use Manning's expression, "shareholders taken as a lot"—have no such interest and no such expectation. Is not our conclusion irreconcilable with this widespread assumption? The answer is no, because the assumption, even if true, is virtually meaningless since it is based on the fallacious premise that the expectations and interest of "the average shareholder" are of great economic or legal significance. This premise is fallacious because corporate economics and corporate law are not bottomed on the democratic principle of one-man-one-vote, but on the proprietary principle of one-share-one-vote. What counts is not shareholders, but shareholdings. An inquiry into the expectations of the average shareholder will therefore be of little more than sociological relevance unless there is a true People's Capitalism, in which shareholders and shareholdings correlate closely. But the opposite is the case: The

128. SPECIAL STUDY, pt. 3, *supra* note 98, at 30. Listed and foreign issues were excluded from the sample.

Similarly, Victor Perlo studied the 1954 reports of public utility and railroad corporations required to report to regulatory agencies on their largest record shareholders, and found that the 20 largest record common stockholders in the three largest railroads, at that time the Pennsylvania, New York Central, and Southern Pacific, held 19.2, 42.6, and 15.3 percent, respectively, of the common stock; that the ten largest record common stockholders in the three largest power companies, P.G.&E., Con. Ed., and Commonwealth Ed., held 10.0, 8.9, 7.7 percent of the outstanding common stock, respectively; and that the figures for smaller railroads and power companies were comparable. (The three largest communications utilities were AT&T, General Telephone, and Western Union. The 20 largest record common stockholders of AT&T and Western Union owned 4.2 and 24.1 percent of such stock, respectively, but figures for General Telephone were not available.) Perlo, "*People's Capitalism*" and *Stock-Ownership*, 48 AM. ECON. REV. 333, 340-41 (1958).

Of course, some record shareholdings may represent a large number of small individual shareholdings held in the name of one broker, but New York Stock Exchange calculations as of 1965 showed that the total amount of publicly held stock held in the name of brokers and dealers was only 7.5 percent by number of shares and 7.1 percent by market value, some of which was undoubtedly owned by the brokers and dealers themselves. See NEW YORK STOCK EXCHANGE, METHODOLOGY AND SAMPLE DESIGN OF 1965 CENSUS OF SHAREOWNERS, Tables III, IV (1965). Similarly, some record shareholders may represent various personal trust funds held in the name of a single bank nominee, but in such cases the holdings for which the bank is trustee are likely to be voted together.

shareholdings of the average shareholder are negligible, and if all the shareholdings of all the average shareholders are aggregated the result is still negligible, because, as is widely recognized (except by stock exchange publicists), the ownership of stock is very highly concentrated. Thus, in *Effects of Taxation—Investments by Individuals*, Butters, Thompson and Bollinger estimated that as of 1949 approximately 4,500,000 spending units owned marketable stock.¹²⁹ Of these, 50,000-100,000, or 1-2 percent, owned approximately 65 percent of total marketable stock, by value, held by individuals; another 950,000 units owned approximately 30 percent of all such stock; and the remaining 3,500,000 units owned approximately five percent.¹³⁰ From a different perspective, a recent Federal Reserve survey estimated that as of 1962, 41 percent of publicly held stock owned by individuals, by value of equity, was held by spending units whose total wealth was 500,000 dollars or more, and 65 percent was held by spending units whose total wealth was 200,000 dollars or more, while only four percent was held by units whose total wealth was less than 25,000 dollars, and only 11 percent was held by units whose total wealth was less than 50,000 dollars.¹³¹ Other studies have reached comparable conclusions. Thus a survey of 2,932 publicly held corporations conducted under the auspices of the Brookings Institution and the New York Stock Exchange showed that as of 1951, 2.1 percent of the shareholdings of common stock in the surveyed corporations accounted for over half of the total value of all such stock while two-thirds of such holdings accounted for only 10 percent of such stock by number and 13 percent by value.¹³²

Given these figures, it may very well be true that the majority of shareholders—"shareholders taken as a lot"—care little about corporate decisions. Why should they, when their stake amounts to five or ten percent of all marketable stock? The question is, what are the interests and expectations of that relatively small number of shareholders who hold the balance? Is it not likely that many of these major holders will own substantial blocks in particular

129. Defined as stock open to investment by the public, that is, listed on an exchange or readily sold over the counter. J. BUTTERS, L. THOMPSON & L. BOLLINGER, *EFFECTS OF TAXATION. INVESTMENTS BY INDIVIDUALS* 373, 402, 499 (1953).

130. See *id.* at 373-89. For a comparable analysis, see STAFF OF SENATE COMMITTEE ON BANKING AND CURRENCY, 84th Cong., 2d Sess., *FACTORS AFFECTING THE STOCK MARKET* 90 (1955).

131. D. PROJECTOR & G. WEISS, *SURVEY OF FINANCIAL CHARACTERISTICS OF CONSUMERS* 136 (1966).

132. L. KIMMEL, *SHARE OWNERSHIP IN THE UNITED STATES* 41-43 (1952). See also Perlo, *supra* note 128, at 337-41.

corporations—substantial either in percentage or absolute dollar terms—and will either be skilled investors or be under the guidance of investment professionals? Is it not likely, in other words, that while “the average shareholder” may not be highly interested in structural changes, those shareholders who own the bulk of shares held by individuals will consider such changes with some care and will expect to have a role in such changes?

Furthermore, “the average shareholder” becomes even less economically and legally relevant when we expand the inquiry to include institutional investors, such as mutual funds and other investment companies, noninsured private pension funds, insurance companies, bank trust departments, and the endowment funds of non-profit institutions.¹³³

(ii) Institutional investors as shareholders in publicly held corporations

(A) The magnitude of institutional shareholdings.—The importance of such investors as shareholders has increased substantially over a long period of time for two reasons: Such institutions have been growing faster than the economy as a whole,¹³⁴ and they have been investing an increasing proportion of their assets in stock, particularly stock in publicly held corporations.¹³⁵ The New York Stock Exchange estimates that as of 1967, financial institutions other than bank trust departments held 22.5 percent of all stock listed on the Exchange by market value—up from 12.7 percent as recently as 1949.¹³⁶ Including bank trust departments, financial institutions held 33 percent of all such stock.¹³⁷ The Exchange also estimates that by 1980 financial institutions other than bank trust departments will hold about 30 percent of all stock listed on the Exchange,¹³⁸ and that the proportion will stabilize eventually at 30-40 percent.¹³⁹ Adjusting these estimates

133. See Henderson, *Institutional Investors in the Equity Market*, in CONFERENCE ON SECURITIES REGULATION 136 (R. Mundheim ed. 1965) [hereinafter cited as DUKE CONFERENCE ON SECURITIES REGULATION]. The major types of nonprofit institutions with important endowment funds are foundations, universities, and hospitals. Another category of institutional investor is the bank or investment counselor acting as administrator of an investment account.

134. NEW YORK STOCK EXCHANGE, INSTITUTIONAL SHAREOWNERSHIP 7-8, 11-13 (1964) [hereinafter cited as INSTITUTIONAL SHAREOWNERSHIP].

135. See INSTITUTIONAL SHAREOWNERSHIP, *supra* note 134, at 8, 13-14; I L. LOSS, SECURITIES REGULATION 17 n.56 (2d ed. 1961, Supp. 1962 at 1); Henderson, *supra* note 133, at 139; cf. Hoenemeyer, *The Life Insurance Company as an Institutional Investor*, in DUKE CONFERENCE ON SECURITIES REGULATION 191; Sheehan, *Life Insurance's Almighty Leap into Equities*, *FORTUNE*, October 1968, at 162.

136. NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 42 (1968).

137. *Id.*

138. INSTITUTIONAL SHAREOWNERSHIP, *supra* note 134, at 59.

139. *Id.* at 63.

to include bank-administered funds, institutional holdings of stock listed on the New York Stock Exchange can be expected to stabilize at 40-50 percent,¹⁴⁰ and there is some reason to believe these figures are understated.¹⁴¹

With total holdings this large, institutional holdings in given corporations must also be substantial. Except in the case of investment companies, little information on such holdings is available,¹⁴² and even in that case the data has not been comprehensively analysed. However, there are enough limited analyses to give a fair picture of the order of magnitude of such ownership:

(1) According to figures compiled by Vickers Associates on the "Favorite Fifty" stocks (by dollar holdings) held by investment companies as of September 1966, such companies owned five to ten percent of IBM, Xerox, Gulf Oil, Minnesota Mining & Manufacturing, Mobil Oil, General Telephone, International Nickel, Royal Dutch, Westinghouse, Merck, Goodyear, Union Oil, RCA, Litton, and Texas Utilities Co.; 10-15 percent of Avon, Continental Oil, Southern Co., Florida Power & Light, Boeing, Gillette, and Sinclair Oil; 15-20 percent of IT&T, CBS, Texas Instruments, United Air Lines, Amerada Petroleum, Anaconda, Pan American, Atlantic Richfield, Magnavox, Louisiana Land & Exploration, and Reynolds Metals; 20-25 percent of Polaroid, Burroughs, Lockheed, and TWA; 26.2 percent of Delta Air Lines; and 41.2 percent of Northwest Airlines.¹⁴³

(2) Many investment companies are grouped into complexes by virtue of being under the management of a common investment advisor. (Ten such complexes accounted for 55 per cent of all mutual fund assets as of June 30, 1966.)¹⁴⁴ The Wharton School's *Study of Mutual Funds* reported that as of 1958, mutual fund complexes owned 1503 holdings of one percent or larger. About half of these holdings were two percent or larger, 183 were five percent or larger, and 62 were eight percent or larger. In each case, this was about twice the size of the comparable figure for 1952, only six years earlier.¹⁴⁵

(3) Looking at this question from the perspective of the portfolio

140. See Henderson, *supra* note 133, at 138.

141. See D. BAUM & N. STILES, *THE SILENT PARTNERS* 6 (1965); Perlo, *supra* note 128, at 343-44.

142. Cf. Louis, *The Mutual Funds Have the Votes*, *FORTUNE*, May 1967, at 150-51, 207; Mundheim, *Foreward*, 29 *LAW & CONTEMP. PROB.* 647, 651 (1964).

143. *Favorite Fifty*, *BARRON'S*, November 28, 1966, at 5.

144. SEC MUTUAL FUND STUDY 247-49.

145. WHARTON STUDY 406-07, 408 (Table VII-4).

corporations, the Wharton Study found that as of 1958, mutual-fund-company holdings of one percent or more accounted for five percent or more of the outstanding voting stock of 297 corporations, and 10 percent or more of the outstanding voting stock of 77 corporations. These figures (which were almost three times as large as comparable 1952 figures) undoubtedly would have been larger if all mutual-fund holdings, rather than only holdings of one percent or more, had been aggregated.¹⁴⁶

(4) The Wharton Study also reported on the holdings of particular complexes in particular portfolio corporations. For example, the Axe-Houghton complex was found to own five holdings of 20 percent or more of a portfolio corporation's outstanding voting stock, three holdings of 10-20 percent, and four holdings of five to ten percent; the National Securities Series had 113 holdings of one percent or more, 18 of which were of five percent or more; IDS had at least 195 holdings of one percent or more, 30 of which were five to ten percent; and MIT had 146 holdings of one percent or more, four of which were five to ten percent.¹⁴⁷

The most striking aspect of these figures is this: As large as they are, they represent only investment company holdings, and of the total New York Stock Exchange shares (by market value) held by all institutional investors, investment companies hold less than 20 percent.¹⁴⁸

(B) The role of the institutional investor as a shareholder.—While the role of the institutional investor as a shareholder has been subject of much debate in recent years, most of the debate has centered on whether such investors owe some obligation to other shareholders in their portfolio corporations to oversee management and attempt to change management when such a change seems necessary.¹⁴⁹ Generally

146. *Id.* at 412 (Table VII-6).

147. *Id.* at 405, 409-410.

Similarly, according to FORTUNE, as of December, 1966, the Fidelity complex owned 5-9.9 percent of Admiral, American Commercial Lines, Beaunit, Bucyrus Erie, Burroughs, Carbourundum, Central Aguirre Sugar, Chicago, Milwaukee, St. Paul & Pac. R.R., Crowell-Collier & MacMillan, Filtrol, General Instrument, General Precision Equipment, Ludlow, Mack Trucks, Maust Coal & Coke, MGM, Newport News Shipbuilding, Northwest Airlines, Pennzoil, Raytheon, Sanders Associates, Transcontinental Bus System, and Vornado, and 10-19.9 percent of Chicago & North Western R.R., Pabst Brewing, Stanley Warner, and Copperweld Steel; and the Dreyfus Fund held at least 17 holdings representing five percent or more of a portfolio company's outstanding common stock. Louis, *supra* note 142, at 151, 205.

148. See NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 42 (1968). This calculation is based on total estimated institutional holdings, including those of bank trust departments.

149. See, e.g., D. BAUM & N. STILES, *supra* note 141, at 149 and *passim*; SEC MUTUAL

speaking, the institutional investors take the position that their primary obligation lies to their own beneficiaries (using this term in its broadest sense, so as to include shareholders in investment companies), not to their fellow shareholders in portfolio companies; that their staffs have neither the time nor the skill to oversee management; and that a company which requires a management change will normally be an unsound investment so that the institutional investor should switch out as quickly as possible rather than stay in and try to accomplish the change.¹⁵⁰

Some of these arguments appear overstated. There must be cases in which a corporation's assets outshine its management, and thus in which an institutional investor would do better by trying to change management than by switching.¹⁵¹ It seems likely that there have been additional, unstated, reasons for backing management, including obedience to the mores of the financial community,¹⁵² a desire to stay on good terms with management in order to promote a free flow of inside information,¹⁵³ and, in the case of certain institutions, particularly banks, a desire to obtain or retain business which management gives the institution in its other capacities. Nevertheless, the position that the primary duty of a financial institution is to protect the interests of its own beneficiaries, and that such institutions are in any event not equipped to oversee management, seems essentially sound.¹⁵⁴

FUND STUDY 27, 307-11; WHARTON STUDY 24-27, 399-428; *Symposium - Mutual Funds as Investors of Large Pools of Money*, 115 U. PA. L. REV. 669, 673-82 (1967).

This debate has focused on only one type of institutional investor, the mutual fund. However, most of the elements that have emerged from the debate are equally applicable to other institutional investors. See Henderson, *supra* note 133, at 136-37. One major difference relates to bank trust funds, since unlike other institutional investors a bank must often consult with third persons before making an investment decision. See Buek, *Trust Companies and Banks as Institutional Investors*, in DUKE CONFERENCE ON SECURITIES REGULATION 147, 148-49 (R. Mundheim ed. 1964).

150. See, e.g., WHARTON STUDY 418-19; Brown, *The Institutional Investor as Shareholder* in DUKE CONFERENCE ON SECURITIES REGULATION 207, 210-12, 217-19, 223-24; Buek, *supra* note 149, at 156; *Symposium, supra* note 149, at 675-82. Another argument is that selling shares itself constitutes a sanction against management. Cf. Manne, *Current Views on the "Modern Corporation,"* 38 U. DET. L.J. 559, 572 n.35 (1961).

151. Cf. WHARTON STUDY 26-27; Louis, *supra* note 142, at 205.

152. Cf. Brown, *supra* note 150, at 217 ("positive action [against management] . . . is never pleasant . . ."); Manning, *supra* note 46, at 1486.

153. See WHARTON STUDY 418-19.

154. As the WHARTON STUDY concluded: "Since the prime responsibility of the management of a mutual fund is the supervision of an investment portfolio, substantial diversion of effort from this activity, or retention of a holding in a company whose management had proven a disappointment, would be difficult to justify in terms of the purported function of this institution." *Id.* at 26.

However, other types of structural changes (other, that is, than changes in management) involve much different considerations. First, while the staffs of financial institutions may not have the skills to oversee business decisions, other types of structural decisions tend to involve precisely the kind of investment analysis at which such staffs are expert — probably more expert than management. (In fact, when structural decisions are being considered, management will frequently consult a financial institution, such as an investment banker, for advice.) Second, a decision to reject a proposed structural change is perfectly consistent with a decision to retain an investment. Indeed, the proposed change may be rejected just because the portfolio corporation is sounder as it stands than it would be if the proposed structural change was made. Finally, although an institutional investor may have no obligation to its fellow shareholders to retain a bad investment, it does have a clear obligation to its own beneficiaries to make sound decisions in connection with the investments it holds. Therefore, unless an institutional investor is prepared to sell every time a structural change is proposed, it is under a fiduciary obligation to use its best judgment in voting on the matter. And this merely reinforces what should be its own self-interest, that is, to maximize its investment performance.

It is therefore to be expected that institutional investors would take a careful interest in structural changes other than changes in management, and the available data indicates that this in fact is what occurs. The Wharton Study found that proxies raising more-than-routine issues, or issues involving policy questions, tended to get careful scrutiny.¹⁵⁵ A recent statement by the president of one of the largest mutual-fund complexes makes the same point:

155. "Particularly among the very large companies, fairly elaborate routines have been sometimes developed whereby proxy requests are automatically turned over to industry specialists, who initially examine each proxy statement. Where the agenda involves issues calling for more careful consideration, the industry specialist usually prepares a memorandum on the issues, along with his recommendations, which are then taken up by an officer or committee of officers. This is roughly the procedure followed by MIT, Investors Diversified Services, Keystone Custodian Funds, and National Securities & Research Corp.

"A more common procedure is one in which proxy solicitations are referred to an officer delegated to handle them, who refers them where deemed necessary to the research staff of the company. Solicitations received by Dividend Shares, e.g., are scrutinized by [the officer in charge of portfolio administration] before being approved for execution. In cases where further study appears indicated, the appropriate industry specialist of the investment adviser is requested to investigate and report his findings. Where basic policy questions are involved, the matter is discussed with the investment committee of the company." *Id.* at 418.

This is not to say that all mutual funds handle proxies this way, but the larger funds, which apparently do, account for more than half of total mutual fund assets. Getting down to specifics, the WHARTON STUDY found that:

Proper exercise of the voting rights on stocks held in the investment portfolios of institutions is a matter of trust and responsibility for the managers. In many respects, it is equal to their responsibilities for the careful selection and supervision of investment holdings. . . .

Unfortunately, there has in the past been some tendency for institutional investors to consider proxy statements and proxies received from portfolio companies in a more or less routine manner. This attitude has changed substantially in recent years as the size of holdings by institutional investors has grown. Even so, it seems important to emphasize the responsibility which each institutional investor has for the proper evaluation of matters submitted for stockholder decision. It seems obvious, but it must be emphasized, that proxy statements and proxies are to be secured in all instances by institutional investors, and each of them must be reviewed carefully by a knowledgeable person in the light of the effect of the issues involved on the status of and prospect for the investment before action to be taken is decided upon. In my opinion, the procedure for processing and voting proxies followed by each institutional investor should have no aspect of the rubber stamp and should permit no built-in bias toward voting in favor of all proposals by corporate management.

I also stress the need for careful consideration of all proxy material by institutional investors because matters included in proxy statements are of the type in which such investors are likely to have the greatest expertise.¹⁵⁶

There has been little study of the attitude of institutional investors other than mutual funds, but the basic attitude-shaping

**Open-end companies have shown a greater willingness to oppose portfolio company managements on matters affecting the voting, preemption, and income rights of shareholders The Wellington Fund has voted regularly against proposals to eliminate preemptive rights of shareholders MIT, National Securities Series, and others, have voted on several different occasions against changes in the voting rights of common stockholders, reduced preemptive rights, increases in common stock issues, the issuance of convertible bonds or preference shares, and similar matters.

. . . .

**Although the smaller open-end companies report few discussions of prospective mergers with portfolio companies, they are of frequent occurrence among the companies (or control groups) with assets in excess of \$150 million. One of the very large companies reports that: 'In cases where the fund is a large holder (and this is the usual case) companies almost invariably submit merger proposals for informal consideration prior to the formal making of the proposal.'" *Id.* at 419-20, 426.

156. Brown, *supra* note 150, at 214-15; *accord*, Louis, *supra* note 142, at 150; Enstam & Kamen, *supra* note 125, at 300; *cf.* R. BAKER & W. CARY, *supra* note 3, at 881 n.1; Mundheim, *The British Experience - Institutions as Shareholders*, THE INSTITUTIONAL INVESTOR, January 1968, at 36.

elements would seem essentially the same.¹⁵⁷ That such institutions do not invariably back management proposals is indicated by the following data which has (more or less fortuitously) become public, showing the number of times trust departments of particular banks voted against management proposals in given years:

<i>Bank</i>	<i>Year</i>	<i>Votes Against Management Proposals</i> ¹⁵⁸
Bankers Trust	1966	3
Irving Trust	1966	5
Chase Manhattan	1966	8
Chemical	1966	10
First National City	1966	7
Morgan Guaranty	1966	0
Security National	1966	0
United States Trust Co.	1963	35
United States Trust Co.	1962	50

The tendency to exercise an independent judgment on structural changes seems likely to increase with the passage of time. Psychologically, the predisposition to vote in management's favor seems to be breaking down. Within the last few years mutual funds have on several occasions gone so far as to vote for insurgent slates of directors.¹⁵⁹ The recent decision in *SEC v. Texas Gulf Sulphur Company*,¹⁶⁰ the radiations of that decision, and the action brought by the SEC against Merrill Lynch, Pierce, Fenner & Smith and a number of mutual funds based on the funds' use of inside information relating to Douglas Aviation,¹⁶¹ are likely to cut deeply into the flow of inside information from management to institutional investors, thereby eroding the economic basis for that predisposition. Finally, as institutional investors soak up an ever larger proportion of total stock, they will come under increasing pressure to maximize performance by cultivating the investments they have, rather than by switching into new ones.¹⁶² This was well put by David Rockefeller, chairman and chief executive officer of the Chase Manhattan Bank:

157. Cf. Henderson, *supra* note 133, at 136-37.

158. Louis, *supra* note 142, at 207; DUKE CONFERENCE ON SECURITIES REGULATION 225 (R. Mundheim ed. 1964).

159. See SEC MUTUAL FUND STUDY 309; Louis, *supra* note 142, at 150.

160. 401 F.2d 833 (2d Cir. 1968).

161. See *Merrill Lynch Penalized by SEC in Insider Case*, N.Y. Times, November 27, 1968, at 1, col. 5.

162. See Sobieski, *In Support of Cumulative Voting*, 15 BUS. L. 316, 321 (1960); *Big-block Buyers May Speak Up*, BUS. WEEK, Nov. 26, 1966, at 139, 140.

I might . . . draw your attention to one important change in savings that is occurring: namely, the tendency for personal savings to flow more and more through institutions—through insurance companies, pension funds, mutual funds and the like—rather than through individual savings accounts. During the 'Sixties, corporations will find themselves dealing increasingly with these sophisticated investors. Moreover, I suspect that such investors will become more demanding of management as time moves on—that as holdings expand, institutions, as well as individuals, will feel obliged to take more active interest in seeing that corporations do indeed have good managements. This will be true especially if their holdings become so large that they cannot readily or quickly liquidate their investments, as is now their practice when they become dissatisfied with the management of a corporation in which they hold shares.¹⁶³

The short of the matter is that at the present time one-third of the stock in corporations listed on the New York Stock Exchange is held by highly sophisticated investors with a growing interest in structural changes other than changes in management; that the proportion of such stock held by such investors will soon reach 40-50 percent; and that much of the balance of the stock of such corporations seems to be held by wealthy individual shareholders with very substantial shareholdings who may be assumed to be either themselves sophisticated investors or guided by professionals in their investment decisions. Only a small fraction of stock even in publicly held corporations appears to be under the direct ownership of unsophisticated investors with tiny holdings. "The average shareholder," who holds center stage in the theories of so many commentators, appears to be only an extra in the real corporate world.

4. *A Normative Model*

In light of the data, it appears that for purposes of determining shareholder expectations publicly held corporations may be divided into two broad classes: those in which one or more shareholdings are relatively large, and those in which all the stock is dispersed in a

163. Address before the Special Conference for Financial Executives of the American Management Association, quoted in D. BAUM & N. STILES, *supra* note 141, at 80.

It should be made clear that I do not view the institutional investors as either the redeemers of what is bad in the corporate system or the enemies of what is good. I do view them as an essential part of the corporate system in fact, whose role must be recognized in any descriptive model and should be recognized in a normative model which is based either on shareholder expectations or on the desirability of finding an offsetting check to management conflict of interest, and possible lack of skill, in the making of structural decisions.

completely atomistic manner. The considerations relating to voting in the former class of corporations do not seem very different than those relating to privately held corporations: On the one hand, a failure to give shareholders power over structural decisions would defeat legitimate and important expectations; on the other, shareholder voting seems desirable as an offset to management conflict of interest, and possibly even lack of management skill, in the making of structural decisions. A normative model of decisionmaking for such corporations would therefore differ from a normative model for privately held corporations in only two respects. First, in the small privately held corporation shareholders may very well expect that they have power to make business decisions outside of the ordinary course on an ad hoc basis. However, as the number of shareholders grows larger, they are likely to expect that all business decisions will be made by management, whether in or out of the ordinary course.¹⁶⁴ Second, as the number of shareholders grows larger, a bargained-out agreement between them becomes all but impossible:

[B]y and large, articles of incorporation are written by management's attorneys [S]tockholders and creditors do not know of the provisions of the articles of incorporation, and, generally, if they did, they would not realize what the consequences of such provisions might be until it is too late.¹⁶⁵

When that point is reached, statutory norms for decisionmaking, although based in whole or in part on shareholder expectations, should not be made subject to variation by shareholder agreement, that is, decisionmaking rules should be mandatory rather than suppletory.¹⁶⁶

A more difficult problem is presented by publicly held

164. Cf. Garrett, *Attitudes on Corporate Democracy—A Critical Analysis*, 51 Nw. U.L. REV. 310, at 310-11 (1956). In part, this is a result of the fact that as the corporation grows larger, decisions out of the ordinary course grow more common and more difficult to distinguish from ordinary-course decisions.

165. Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 Nw. U.L. REV. 1, 9 (1955).

166. Actually, this point is applicable even to many corporations we have referred to, for other purposes, as privately held, since a corporation with, say, 100 shareholders, may be considered so widely held that bargained-out agreements are not really possible. Thus close corporation treatment under the new Delaware statute can be elected only by corporations with less than 30 shareholders. See DEL. GEN. CORP. LAW § 342(a)(1) (1967). New York approaches the problem somewhat differently: An important enabling provision for close corporations under the New York statute is applicable only where "no shares of the corporation are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association." N.Y. BUS. CORP. LAW § 620(c) (McKinney Supp. 1967).

corporations all of whose stock is atomistically dispersed. Considerations of public policy, other than the protection of the fair expectations and economic interests of shareholders, are neutral: There is nothing to indicate that either management, client-groups, or the shareholders themselves are capable of determining what the general public interest requires, or willing to put that interest ahead of their personal interests. Nor is there anything to indicate that the personal interests of any one of these classes is more or less close to the general public interest than those of the others. Nevertheless, where all the stock is atomistically dispersed, elimination or reduction of voting rights could be theoretically justified on the ground that it is less likely to frustrate shareholder expectations than would be the case where large holdings were present.

But even if such treatment could be theoretically justified, it seems unlikely that a statutory definition could be formulated which would adequately identify such corporations. Such a definition could not be drafted in terms of number of shareholders: Ford, with 433,000 shareholders, and duPont, with 241,000, both have large concentrated blocks of shares outstanding.¹⁶⁷ It could not be drafted in terms of absolute size: The 15 largest nonfinancials, by assets, include Ford, in which the Ford family has 40 percent of voting power; Gulf Oil, in which the Mellon interests control 29 percent of the capital stock; and Sears, Roebuck, in which the Sears, Roebuck Savings and Profit Sharing Pension Fund owns 24.9 percent of the outstanding common stock.¹⁶⁸ In theory, such a definition could be drafted in terms of atomization itself—for example, the statute might withhold voting rights where no single shareholding exceeded one percent. But in practice such a rule would take in very few corporations,¹⁶⁹ and in any event would be intolerable, because voting rights in a given corporation would continually blink on and off as large investors accumulated or sold shares.

Apart from the definitional problem, there are several reasons why elimination or reduction of voting rights would appear to be substantively undesirable, even in corporations whose shares are atomistically dispersed. Undoubtedly, a shareholder holding only a minute fraction of a corporation's stock has less of an expectation of participating in corporate decisionmaking than does a shareholder with a relatively large holding. But it is not completely clear, as seems

167. See NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 27; Larner, *supra* note 93, Appendix.

168. See Larner, *supra* note 93, Appendix.

169. See text accompanying notes 89-148 *supra*.

to be commonly assumed, that such a shareholder has no expectation of participating. While hard data does not appear to be available, many such shareholders seem to regularly fill out and return their proxies. This suggests, at least, that such shareholders regard shareholder voting as a meaningful process, in which they want to participate.

Moreover, while it is undoubtedly true that shareholders with small holdings normally support management candidates and management proposals, it is far from clear they do so by reflex. It is only natural for shareholders to assume management's action is well-advised, and it would probably be an inefficient allocation of time for even the largest of shareholders to review every management decision de novo.¹⁷⁰ But a decision to support management proposals in the normal course of events no more implies surrender of the right to vote against such proposals where they seem inexpedient, than a decision to review one's bank statements in only a desultory way implies a surrender of the right to challenge a statement which seems to be in error.¹⁷¹ Within recent years, New York Central's management lost a proxy fight, M-G-M's management almost lost, and a number of proposals for structural change in large corporations have failed of passage, or have been withdrawn because of shareholder opposition, or have passed by only narrow margins.¹⁷² The case that shareholders with small holdings do not regard shareholder voting as an important process is yet to be conclusively proved.

Furthermore, even if it were so proved, there are factors other

170. See R.A. GORDON, *supra* note 67, at 171-88, showing that even dominant and sophisticated shareholders such as the duPonts or Rockefellers may seldom intervene in the affairs of corporations they control.

171. Cf. Manne, *Current Views on the "Modern Corporation."* *supra* note 150, at 577, n.54. Of course, the small shareholder normally cannot determine an outcome with his vote, and he knows it; but the political voter also cannot normally determine an outcome, and knows it, and yet casts his vote and regards it as important that he does so. This is not to say that the psychologies of political and shareholder voting are identical, but only that speculation concerning the psychology of shareholder voting has far outraced the data.

172. See, e.g., *Levin v. M-G-M, Inc.*, 221 A.2d 499 (Del. Ch. 1966); *Allis and Signal End Merger Plan*, N.Y. Times, January 17, 1968, at 61, col. 2; *Alpha Portland Surrenders In Its Pursuit of Proxies*, Wall Street J., May 2, 1968, at 6, col. 4; *Cook Electric Drops Merger Plan, Cities Opposition by Lab for Electronics Group*, Wall Street J., January 26, 1968, at 12, col. 1; *Gearhart-Owen Meeting Adjourned Due to Low Number of Proxies Cast*, Wall Street J., 1968, at 7, col. 2; *General Public Utilities Drops Consideration of Payout Policy Shift*, Wall Street J., April 2, 1968, at 11, col. 1; *Missing Proxies Upsetting Annual Meetings At Unusual Rate; Brokers' Logjam Blamed*, Wall Street J., May 8, 1968, at 8, col. 2; *Plan for Southwestern Life American General Merger Is Called Off*, Wall Street J., July 24, 1968, at 5, col. 3; *Republic Investors Merger Spurned by Shareholders*, Wall Street J., July 16, 1968, at 20, col. 4; *Transamerica Offer to Buy Management Assistance is Canceled*, Wall Street J., August 9, 1967, at 4, col. 2.

than shareholder expectations which bear on the desirability of shareholder voting in publicly held corporations. One factor, which we have already considered, is that voting tends to add meaning and force to disclosure, which is universally recognized as an important and desirable check on improvident management action.

There is another, more complex consideration, which is often overlooked: Even when all the stock in a corporation is so atomistically dispersed that existing shareholders cannot effectively use their votes, the vote is nevertheless something of value because of the potentiality that the shareholding pattern will change; because, to use Professor Manne's apt description, of the "interplay of share voting and share transferability."¹⁷³ Assuming there is a rough relationship between management efficiency (in the broadest sense of that term) and stock prices,¹⁷⁴ the shares of a corporation which is inefficiently managed will tend to be underpriced in relation to their potential value. When the differential reaches a certain point it becomes more and more likely that an outsider will attempt to acquire sufficient shares to obtain control, with the ultimate objective of installing efficient management, thereby causing the acquired stock to appreciate in value to its full potential.¹⁷⁵ This phenomenon—the takeover—has become increasingly common within the last few years, and as the technique has been perfected it has been extended to the very largest of corporations. In 1966-67, for example, Ling-Temco-Vought took over Wilson Meat Packing, then one of the 100 largest industrials,¹⁷⁶ through a cash tender offer.

Such takeovers benefit both shareholders as a class (since the outsider will usually pay a premium over market price to acquire the shares, and since the very possibility of a takeover may be expected to stimulate management efficiency), and society as a whole (since a takeover often results from the possibility of efficiently utilizing resources which have theretofore been inefficiently utilized). However, such takeovers are premised on the existence of voting shares, because unless the outsider can obtain voting control, he cannot oust incumbent inefficient management and therefore has no incentive to

173. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 413 (1962).

174. See Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 1967 DUKE L.J. 231, 236; Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 & n.10 (1965).

175. See Manne, *Mergers and the Market for Corporate Control*, *supra* note 174, at 113; Manne, *Cash Tender Offers*, *supra* note 174, at 236; Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1430-31 (1964).

176. *Fortune Directory*, FORTUNE, July 15, 1966, at 234.

acquire shares in the first place. Any weakening of shareholders' legal right to control the constitution of management therefore seems highly inadvisable, even in the case of the corporation in which existing shareholders have no meaningful voice because of an atomistic dispersion of stock.

The classic takeover is effected through a cash purchase of shares by the outsider. If we were concerned merely with this type of takeover, it might be argued that it is sufficient to permit shareholders in corporations with atomistically dispersed stock to vote on matters of corporate control, rather than on all structural matters. However, as Professor Manne has pointed out,¹⁷⁷ a corporate combination can provide an alternate route to the conventional cash takeover—and a route which may be more desirable both from the shareholders' and the outsider's perspective. Assume that Survivor Corporation feels that the management of Transferor Corporation is inefficient and that Transferor's shares are therefore underpriced. A cash takeover may require a relatively large amount of cash, and will result in a taxable transaction for Transferor's shareholders.¹⁷⁸ If, however, Survivor can acquire Transferor's assets for its own stock it will not need access to a large amount of cash, and the transaction may be tax-free.¹⁷⁹ (Also, Transferor's shareholders may end up with a greater portion of the potential appreciation in Transferor's assets, which they will realize through their ownership of Survivor stock.) But this alternative to a cash takeover may not be feasible where Transferor's shareholders have no power to effectuate a combination, and will be most feasible where such shareholders have *exclusive* power to effect a combination. Assume that Survivor is willing to pay some aggregate amount to acquire control of Transferor, and call the difference between that aggregate amount, and the aggregate market price of Transferor's shares prior to Survivor's takeover bid, the premium. When Survivor has indicated its desire to gain control of Transferor, Transferor's management has three possible courses of action. It may unqualifiedly resist; it may unqualifiedly acquiesce; or it may acquiesce on condition that some part of the premium be diverted to it, as through employment contracts. Of course, Transferor's management can follow any of these three courses whether or not its legal approval is required for the takeover, since as a practical matter even if management's approval is not legally required it is in a position to

177. See Manne, *Mergers and the Market for Corporate Control*, *supra* note 174, at 117-19; Manne, *Some Theoretical Aspects of Share Voting*, *supra* note 175, at 1432-34, 1437-39.

178. See INT. REV. CODE OF 1954, § 61(a)(3).

179. See text accompanying notes 325-35 *infra*.

either facilitate or obstruct a takeover. But management's bargaining power is clearly enhanced to the extent that its approval is legally required, and weakened to the extent that it is not.¹⁸⁰ The greater the control which Transferor's shareholders have over combinations, therefore, the greater the amount of the premium which may be expected to come into their hands; the less their legal control, the greater the amount of premium which may be expected to be diverted into management's hands.¹⁸¹ If it is assumed that the legal system should maximize the amount of such a premium which goes to shareholders and minimize the amount which goes to management, then the legal system should maximize the shareholders' legal control over combinations.¹⁸²

In short: (1) The normative model of the publicly held corporations whose stock is not atomistically dispersed should follow that of the privately held corporation as regards voting rights, except that statutory decisionmaking rules should not be subject to variation, and management should have exclusive power over all business decisions; (2) If voting rights were based solely on shareholder expectations, a normative model of publicly held corporations whose

180. Cf. Manne, *Mergers and the Market for Corporate Control*, *supra* note 174, at 118; Manne, *Some Theoretical Aspects of Share Voting*, *supra* note 175, at 1437-38.

181. It is not enough, in this connection, that shareholders have power to elect directors, since this power usually cannot be exercised until the incumbent directors' terms expire. See text accompanying note 5 *supra*. By that time, the iron may be cold. Furthermore, where directors serve for staggered terms it could take two or more years for a newly constituted majority of shareholders to gain control of the board.

182. One other factor is relevant to the question of shareholder voting in the publicly held corporation: whether it is more desirable to have economic decisions made by the government or by autonomous nongovernmental institutions. Probably it is only private ownership that has insulated the giant corporation from direct government control since such ownership, and its ultimate legal right to elect the management and control certain key aspects of the corporate institutions, has given legitimacy, under our system of values, to the management of such institutions. Cf. Mason, *supra* note 30, at 17. Under the voteless model this particular source of legitimacy, at least, would be lacking, and while over the course of time some other source of legitimacy might be established, it seems more likely that the eventual denouement of a voteless model would be direct government intervention. Cf. Harris, *supra* note 165, at 2: "In times of great prosperity, expansion and promotion, corporate lawyers often view restrictive, protective measures as unnecessary obstacles. However, like lifeboats which appear to unnecessarily clutter the decks during fine sailing weather, some corporate safeguards are worth carrying through fair weather for protection when the Dow-Jones barometer goes down and the economic seas are rough"; Manne, *Current Views on the "Modern Corporation"*, *supra* note 150, at 577 n. 53: "Voting is after all the only system—in a society which has ceased believing in magic or the divine right of kings—which makes a real claim on the loyalty of losers as well as winners of political power." Whether direct government control would be better or worse than the present corporate system is beyond the scope of this Article; but it does seem that one who favors such control would be well-advised to work for a voteless model, and one who opposes it would be well-advised to work toward strengthening of shareholder control. Cf. J. BURNHAM, *THE MANAGERIAL REVOLUTION* 139-41 (Midland ed. 1960); R. EELLS, *supra* note 1, at 257-62; Vagts, *supra* note 38, at 79.

stock was atomistically dispersed might eliminate such rights. However, in practice it would be difficult to draft an adequate statutory definition of such corporations, and in any event such treatment would seem substantively undesirable since voting rights in publicly held corporations should be based not only on shareholder expectations, but also on the desirability of strengthening the force of disclosure, and on considerations stemming from the interplay between shareholder voting and share transferability.

C. The Statutory Models of Decisionmaking

On moving from the received and normative models to the corporate statutes, the first impression is one of enormous disparity. For one thing, the decisionmaking patterns embodied in the statutes seldom conform to those of the models. For another, the statutes cover only a few of the kinds of corporate actions that may be "fundamental," to use the terminology of the received legal model, or "structural," to use the terminology of the normative models—namely, mergers, sales of substantially all assets, certificate amendments, and dissolution. (These actions are often collectively referred to, sometimes together with reduction of capital, as "the" fundamental changes, and will hereafter be referred to as the traditional fundamental changes.)

In this section I will begin an evaluation of the corporate statutes in light of the normative models, and an examination of the descriptive accuracy of the received legal model. Both inquiries will be completed in Part II. Methodologically, in this and subsequent sections of the Article, when dealing with statutory provisions I will not attempt to canvass the statutes of the fifty-odd corporate jurisdictions, but instead will focus on the provisions of eight statutes: the Model Business Corporation Act, and the corporate laws of California, Delaware, Illinois, New Jersey, New York, Ohio, and Pennsylvania. The Model Act is selected because since 1950 approximately 20 states have used it as a basis for new business corporation acts or as a source for important revisions.¹⁸³ The seven designated states are selected because, with the Model Act, they tend to serve as sources for corporate law revision in other states; because they provide both a fair representation of corporate statutes and a fair

183. See 1 ABA MODEL BUS. CORP. ACT ANN. v, 4 (1960), and Supp. 1966, at 3, 14. For a chart depicting the extent to which the Act has influenced the statutes of these jurisdictions, see R. STEVENS & H. HENN, STATUTES, CASES, AND MATERIALS ON CORPORATIONS AND OTHER BUSINESS ENTERPRISES 26-27 (1965).

spread of corporate philosophy, from regulatory California through permissive Delaware; and, perhaps more important, because whether one looks to the large or the small corporation, under any economic test they are the dominant corporate jurisdictions.¹⁸⁴

1. *The Statutory Decisionmaking Patterns*

(a) *Mergers.*—The statutory merger is the traditional method for effecting a corporate combination.¹⁸⁵ Although the term “merger” is frequently used in the statutes without being clearly defined,¹⁸⁶ it is generally understood to be a process by which one corporation, which will hereafter be called the transferor, is absorbed by another

184. The economic significance of these jurisdictions as corporate domiciles can be brought out by a few figures. On the one hand, they account for approximately 45 per cent of all new corporations, New York alone accounting for approximately 17 per cent. See DUN & BRADSTREET, *NEW BUSINESS INCORPORATIONS BY STATES 1962-1966*. On the other, they account for approximately three-quarters of all corporations listed on the New York Stock Exchange. Delaware alone accounts for more than one-third of such corporations, and Delaware and New York for almost half. CORPORATION SERVICE COMPANY, *THE RED BOOK DIGEST OF DELAWARE CORPORATE PROCEDURES* i (1968). According to the 1967 *Fortune Directory*, these seven states account for eighty-seven of the ninety-eight nonfinancial corporations with sales or operating revenues in excess of 1 billion dollars in 1966. *Fortune Directory*, FORTUNE, June 15, 1967, at 196-213, 220-25. (Forty-one were incorporated in Delaware, 18 in New York, 9 in New Jersey, 7 in Pennsylvania, 6 in Ohio, 4 in Maryland, 3 each in California and Illinois, and 1 each in seven other states). These jurisdictions also accounted for 87 of the 100 industrials with sales in excess of 800 million dollars (46 were incorporated in Delaware, 13 in New York, 10 in New Jersey, 7 in Ohio, 6 in Pennsylvania, 4 in Maryland, 3 in California, 2 each in Illinois and Maine, and 1 each in seven other states); 19 of the 25 merchandising firms with sales in excess of 550 million dollars (7 each were incorporated in Delaware and New York, 2 each in Illinois, Maryland, and Ohio, and 1 each in five other states); 9 of the 15 transportation companies with operating revenues in excess of 500 million dollars (7 were incorporated in Delaware, 3 in Virginia, and 1 each in five other states, including New York and Pennsylvania); and 20 of the 25 utilities with assets in excess of 901 million dollars (7 were incorporated in Delaware, 6 in New York, 3 in California, 2 in Illinois, and 1 each in seven other states, including New Jersey and Pennsylvania.)

The significance of Delaware as a corporate domicile has increased since 1967. See note 388 *infra*. Financial corporations are not considered in this Article because they are frequently marked out for special statutory treatment rather than being covered by general corporation laws. 1 ABA MODEL BUS. CORP. ACT ANN. 31 (1960); see, e.g., N.Y. BUS. CORP. LAW § 103 (McKinney 1963) *as amended*, (McKinney Supp. 1967); Act 216, § 2.1, [1968] Purdon's Pa. Leg. Service 426.

The jurisdictions in question achieve their domination, of course, through the traditional choice-of-law rule that questions relating to internal corporate affairs are governed by the law of the state of incorporation. See note 423 *infra*.

185. Comment, *Statutory Merger and Consolidation of Corporations*, 45 YALE L.J. 105, 106 (1935). For purposes of simplicity, in this Article the term “merger” will be used to include consolidations in which two corporations fuse to form a third, new corporation, and mergers themselves will be discussed only in terms of two constituent corporations. Consolidations and mergers involving more than two constituents are rare, and seldom raise legal problems differing from two-party mergers.

186. See text accompanying notes 315-20 *infra*.

corporation, which survives.¹⁸⁷ By operation of law the survivor succeeds to all of the transferor's assets, rights, and liabilities.¹⁸⁸ Normally the statute requires a merger agreement or plan, which sets out the terms and conditions of the merger, including the ratio of exchange of shares.¹⁸⁹ Frequently the agreement also contains the names of the persons who will be officers and directors of the survivor.¹⁹⁰

Clearly, a merger will often, if not invariably, qualify as a "fundamental" or "structural" change, and if the received legal model is accurate it would follow that, generally speaking, mergers would be a shareholder matter under the statutes. In fact, however, while the statutes give shareholders a voice in mergers, it is a very small voice indeed. To begin with, the statutes provide that a merger normally must be approved not only by the shareholders, but also by the board.¹⁹¹ Furthermore, they usually require that the merger agreement be adopted by the board before it is passed on by the shareholders, and limit the shareholders' power to approval or disapproval of the package formulated by the board, rather than giving shareholders the right to take a proposed merger and reformulate its details.¹⁹² This is a far cry from the received legal

187. See, e.g., I G. HORNSTEIN, CORPORATION LAW AND PRACTICE 470 n.89 (1959, Supp. 1968); cf. N.Y. BUS. CORP. LAW § 901(a)(1) (McKinney 1963), as amended, (McKinney Supp. 1967).

188. See, e.g., DEL. GEN. CORP. LAW § 259(a) (1967); ABA MODEL BUS. CORP. ACT. §§ 69(c)-(e) (1960).

189. See, e.g., DEL. GEN. CORP. LAW § 251(b) (1967).

190. Cf. Baldwin, Booz, Geraghty, Hale & Smith, *The Urge to Merge*, CORP. PRACTICE COMMENTATOR, Nov. 1961, at 1, 63; OHIO REV. CODE ANN., tit. 17, § 1701.78(B)(8) (1964).

191. 2 ABA MODEL BUS. CORP. ACT ANN. 321 (1960); see CAL. CORP. CODE §§ 4100, 4103, 4107, 4108 (West Supp. 1968); DEL. GEN. CORP. LAW §§ 251(a)-(c) (1967); ILL. ANN. STATS. ch. 32, §§ 157.61, 157.63, 157.64 (Supp. 1966); N.J. REV. STAT. § 14A: 10-1-3 (Supp. 1968); N.Y. BUS. CORP. LAW §§ 902, 903 (McKinney 1963); OHIO REV. CODE ANN. §§ 1701.78, 1701.79 (1964); PA. STAT. ANN. § 1902 (1967), as amended, Act 216, § 45, [1968] Purdon's Pa. Leg. Service 454; ABA MODEL BUS. CORP. ACT ANN. §§ 65, 67 (1960).

New York, which did not require board approval prior to 1961, fell into line that year when it adopted its new Business Corporation Law. See Revisers' Notes to N.Y. BUS. CORP. LAW § 902 (McKinney 1963).

Under some provisions it may be arguable that "the statutory requirement of a vote by the board of directors [is] a purely administrative or ministerial device preliminary to a shareholder vote," and therefore not an absolute requirement. Manne, *Some Theoretical Aspects of Share Voting*, *supra* note 175, at 1437 n.28; cf. Ward, *The Legal Effect of Merger and Asset Sale Agreements Before Shareholder Approval*, 18 W. RES. L. REV. 780, 788-90 (1967). There appears to be no case on the question, but the language of most statutes makes the argument doubtful (as Professor Manne recognizes, see Manne, *supra*, at 1437), and the SEC has expressly ruled that board approval cannot be dispensed with. See Clusserath, *The Amended Stockholder Proposal Rule: A Decade Later*, 40 NOTRE DAME LAW. 13, 25-26, 47 (1964).

192. See the Delaware, Illinois, New Jersey, New York, Ohio, Pennsylvania, and Model

model, with its implicit or explicit suggestion that shareholders have plenary power over fundamental changes.¹⁹³ By vesting in the board not only the concurrent power to approve, but the exclusive power to initiate and formulate details, the statutes render mergers primarily a management matter. It would be possible to require board approval and yet permit shareholder initiation, and in fact California does just that.¹⁹⁴ Or, it would be possible to require that a merger with a given corporation be initiated and approved by the board, and yet permit shareholders to formulate or reformulate details, and such a pattern is not uncommon in connection with the sale of substantially all assets.¹⁹⁵ Instead, the statutes not only give the board a formal voice in mergers—a result which itself seems unwise, for reasons already examined¹⁹⁶—but assign to the board a major and decisive legal role.

On the other hand, there are several respects in which the statutory model governing mergers gives shareholders greater rights than the received legal model explicitly contemplates. The received legal model contemplates that shareholders have power to make fundamental decisions. Consistent with that model, the statutes could provide simply that a merger required the approval of the holders of a majority of the shares present at a meeting called to consider it, provided a quorum was present. Instead, the statutes usually require that a merger be approved by the holders of a certain fraction of outstanding shares—usually two-thirds.¹⁹⁷ Thus a merger must have

Business Corporation Act provisions cited in note 191 *supra*. The shareholders' lack of power to reformulate details might be analogized to the House of Representatives' lack of power to amend a bill sent to the floor by the Rules Committee under a closed or gag rule. See D. BERMAN, IN CONGRESS ASSEMBLED 212-13 (1964); Robinson, *Decision Making in the House Rules Committee*, 3 AD. SCI. Q. 73, 77 (1958).

The statutes also commonly permit the merger agreement to provide that the board can terminate the merger at any time prior to filing of the merger certificate without further shareholder action. See, e.g., DEL. GEN. CORP. LAW. § 251(d) (1967); ABA MODEL BUS. CORP. ACT ANN. § 67 (1960). California goes further, and permits the board to abandon a merger following shareholder approval even if the merger agreement does not so provide. CAL. CORP. CODE § 4112 (West 1955).

193. *Cf.* Ward, *supra* note 191, at 789-90.

194. See the California provisions cited in note 191 *supra*. Compare the legal power of the Mayor of New York City to formally introduce budget legislation in the City Council. See NEW YORK, N.Y. CITY CHARTER §§ 116-21 (1963).

195. See text accompanying note 203 *infra*. Compare the item veto power which most governors have over appropriations legislation. See W. KEEFE & M. OGUL, THE AMERICAN LEGISLATIVE PROCESS 403 (2d ed. 1968).

196. See text accompanying notes 63-77, 173-82 *supra*.

197. All of the statutes under consideration require approval by the holders of at least two-thirds of the outstanding voting shares, except for the New Jersey and Pennsylvania statutes, which only require approval by a majority of the outstanding shares. See statutes cited in note

active shareholder support; those shareholders who don't care enough to vote in favor, in effect, vote against. The net result is to give the shareholders as a body a legal role not unlike the legal role of the President in the legislative process. Like the Congress, the board is given exclusive power to determine whether a matter should be considered and to formulate details, and concurrent power to approve. Like the President, the shareholders' only legal powers are to recommend to the board that it consider a matter, and to approve, disapprove, or withhold approval—as by veto or pocket veto—of matters which reach them, full-blown, from the board.¹⁹⁸ This type of statutory model will therefore be referred to hereafter as a veto model. But it must be kept in mind that by normally requiring two-thirds approval, the statutes give a veto not only to the shareholders as a body, but also to minority shareholders, at least to a minority of sufficient size (one-third of outstanding shares plus one).

The traditional merger statutes give another right to minority shareholders which is not reflected in the received legal model. In most cases a shareholder who formally objects to a proposed merger in a specified way (and thereafter follows a detailed and technical route) can require the corporation to buy his shares from him at their "value," "fair value," "fair market value," or the like—the precise test depending upon the jurisdiction—such price to be normally determined in the first instance by judicially-appointed appraisers,¹⁹⁹ in the absence of agreement by the parties. The place of this right in a normative model will be discussed below.²⁰⁰

(b) *Sale of substantially all assets.*—The provisions governing the sale of substantially all assets adopt still other models of decisionmaking. All of the statutes under consideration require both

191 *supra*. Some of the statutes require approval by two-thirds of all shares (voting or nonvoting), *see, e.g.*, DEL. GEN. CORP. LAW § 251(c) (1967), or two-thirds of the shares of each class, *see, e.g.*, CAL. CORP. CODE § 4107 (West Supp. 1968).

198. *See* U.S. CONST. art. 1, § 7, art. 11, § 3; *cf.* Kessler, *supra* note 14, at 701. The President also has the power to call a special session, U.S. CONST. art. 11, § 3, but "[t]oday, when the legislature normally meets for eight or nine months of the year, this power is of slight consequence." E. REDFORD, D. TRUMAN, A. WESTIN, & R. WOOD, *POLITICS AND GOVERNMENT IN THE UNITED STATES* 302 (2d ed. 1968).

Needless to say, we are focusing here on *legal* power. The President's actual role in the legislative process is, of course, much greater than his legal role would indicate, *see, e.g.*, W. KEEFE & M. OGUL, *supra* note 195, at 397-422, just as the actual role of a controlling shareholder is normally much greater than his legal role would indicate.

199. *See, e.g.*, CAL. CORP. CODE § 4300 (West Supp. 1968) ("fair market value"); DEL. GEN. CORP. LAW § 262(b) (1967) ("value"); ABA MODEL BUS. CORP. ACT ANN. §§ 73(a), 74 (1960) ("fair value").

200. *See* text accompanying notes 233-67 *infra*.

shareholder and board approval of such sales;²⁰¹ however, while most of the statutes also give the board exclusive power to initiate,²⁰² they usually provide that once the board has initiated a proposal to sell, the shareholders can fix terms.²⁰³ In such cases the legal role of the shareholders is not merely that of a veto-holder; rather, it resembles that of an administrative agency which is given discretionary power to determine the scope, if any, of a legislative enactment.²⁰⁴ Furthermore, some of the statutes permit shareholder initiation in this area.²⁰⁵ In such cases the legal roles of board and shareholders are equal. But in no case do the shareholders have plenary power over sales of substantially all assets. The board always has at least a veto, in effect, through its power to withhold approval. This gives management a power it may use to keep itself in office by refusing to agree to a sale, or by agreeing only on condition that part of the price be diverted to it through employment agreements with the acquiring corporation. No reason is apparent why such a role should be deemed necessary.

Most of the statutes require approval by two-thirds of the

201. CAL. CORP. CODE § 3901(b) (West 1955); DEL. GEN. CORP. LAW § 271 (1967); ILL. ANN. STAT. ch. 32, § 157.72 (Smith-Hurd 1954); N.J. REV. STAT. § 14A: 10-11 (Supp. 1968); N.Y. BUS. CORP. LAW § 909(a) (McKinney Supp. 1967); OHIO REV. CODE ANN. § 1701.76(A) (Page 1964); PA. STAT. ANN. tit. 15, § 1311(B) (1967); ABA MODEL BUS. CORP. ACT ANN. § 72 (Supp. 1966).

However, many statutes explicitly, e.g., ILL. ANN. STAT. ch. 32, § 157.71 (Smith-Hurd 1954); PA. STAT. ANN. tit. 15, § 1311(a) (1967), or implicitly, e.g., OHIO REV. CODE ANN. § 1701.76(a) (Page 1964), provide that shareholder approval is not required for a sale made in the regular course of business, and courts often read in such an exception even without statutory help. See *Van Buren v. Highway Ranch, Inc.*, 46 Wash. 2d 582, 283 P.2d 132 (1955); Note, *Disposition of Corporate Assets*, 43 N.C.L. REV. 957, 960 (1965). Some courts take the position that the statutes are inapplicable where the corporation is insolvent, or in failing circumstances or financial distress, but there is a split of authority on this issue, and also on whether if the statute is inapplicable the result is to dispense with the need for board or for shareholder approval. See *Teller v. W.A. Griswold Co.*, 87 F.2d 603 (6th Cir. 1937); *Michigan Wolverine Student Co-operative, Inc., v. Wm. Goodyear & Co.*, 314 Mich. 590, 22 N.W.2d 884 (1946); *Carrier v. Dixon*, 142 Tenn. 122, 218 S.W. 395 (1919); Comment, *Sale of All or Substantially All of Corporate Assets*, 45 MICH. L. REV. 341 (1947); Note, *Disposition of Corporate Assets*, 43 N.C.L. REV. 957, 959 (1965); Comment, *Fundamental Corporate Changes*, 28 TENN. L. REV. 529, 544-45 (1961); Note, *Stockholder Consent to Sales of Integral Corporate Assets: Balancing Dissenter and Purchaser Interests*, 67 YALE L.J. 1288 n.2 (1958).

202. See the Illinois, New Jersey, New York, Pennsylvania, and Model Act provisions cited in note 201 *supra*.

203. See ILL. ANN. STAT. ch. 32, § 157.72(c) (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 909(a)(3) (McKinney Supp. 1967); PA. STAT. ANN. tit. 15, § 1311(B) (1967); ABA MODEL BUS. CORP. ACT ANN. § 72(c) (Supp. 1966). *But see* DEL. GEN. CORP. LAW § 271 (1967); N.J. REV. STAT. § 14A: 10-11(1)(c) (Supp. 1968).

204. See, e.g., Securities Exchange Act of 1934, §§ 9(a)(6), 9(b), 10, 13(a), 14(a), 15 U.S.C. §§ 78i(a)(6), (b), 78j, 78m(a), 78n(a) (1964).

205. See CAL. CORP. CODE §§ 3901, 3902 (West 1955); OHIO REV. CODE ANN. § 1701.76(A) (Page 1964).

shareholders for a sale of substantially all assets,²⁰⁶ but some require approval by only a majority, even while requiring two-thirds approval of a merger.²⁰⁷ This creates a significant tension between the merger and sale-of-substantially-all-assets provisions.²⁰⁸ A second source of tension between these provisions arises from the fact that while most statutes provide for appraisal rights in the case of both mergers and sales of substantially all assets,²⁰⁹ some provide for appraisal rights only in the case of mergers.²¹⁰ The effects of these tensions will be explored further in Part II.

(c) *Amendment of the certificate of incorporation.*—Under some statutes the pattern governing amendment of the certificate is that of the received legal model: The shareholders have plenary power to amend, without the legal necessity of board initiation, board formulation, or board approval.²¹¹ But under most statutes the pattern governing certificate amendment is the veto model: The board is given concurrent power of approval and exclusive power to initiate and formulate details.²¹² Again, this seems highly undesirable on a blanket basis. Frequently the certificate contains provisions relating to control of the corporation—for example, provisions governing the size of the board, or classifying the board so that only a portion of its seats come up for reelection in any one year. Where this is the case, the board could use such a power to frustrate or at least delay the efforts

206. See the Illinois, New York, Ohio, and Model Business Corporation Act provisions cited in note 201 *supra*.

207. See the California and Delaware provisions cited in notes 201 and 205 *supra*.

208. See text accompanying notes 283-308 *infra*.

209. See ILL. ANN. STAT. ch. 32, §§ 157.70, 157.73 (Smith-Hurd Supp. 1966); N.J. REV. STAT. § 14A:11-1 (Supp. 1968); N.Y. BUS. CORP. LAW § 910(a)(1) (McKinney 1963); OHIO REV. CODE ANN. §§ 1701.76(C), 1701.81(B) (Page 1964); Act 15; §§ 1311(D), 1908 [1968] Purdon's Pa. Leg. Service 433-34; ABA MODEL BUS. CORP. ACT ANN. §§ 73, 74 (1960).

210. See CAL. CORP. CODE § 4300 (West Supp. 1967); DEL. GEN. CORP. LAW § 262 (1967).

211. N.Y. BUS. CORP. LAW § 803(a) (McKinney 1963), *as amended*, (McKinney Supp. Sept. 1965); OHIO REV. CODE ANN. § 1701.71 (Page 1964); PA. STAT. ANN. tit. 15, §§ 1802, 1805 (1967). In New York this power is limited to some extent by the fact that only the board can call special shareholders' meetings, absent specific certificate or bylaw provisions. N.Y. BUS. CORP. LAW § 602(c) (McKinney 1963), *as amended*, (McKinney Supp. 1965). However, Ohio permits such meetings to be called by 25 percent of the voting shareholders. OHIO REV. CODE ANN. § 1701.40(A)(3) (Page 1955). Pennsylvania provides that a certificate amendment may be proposed by 10 percent of the shareholders, and the board must then submit the proposal to a vote at "a designated meeting, which may be either an annual . . . or a special meeting." PA. STAT. ANN. tit. 15, § 1802 (1967). Query whether the board could refuse to call a special meeting if the annual meeting date was far off.

212. DEL. GEN. CORP. LAW §§ 242(a), (d)(1) (1967); ILL. ANN. STAT. ch. 32, § 157.53 (Smith-Hurd 1954); N.J. REV. STAT. § 14A:9-2 (Supp. 1968); ABA MODEL BUS. CORP. ACT ANN. § 54 (1960). See generally 2 ABA MODEL BUS. CORP. ACT ANN. 225 (1960).

of newly dominant shareholders to oust management, a fact which may itself discourage an outsider from attempting to take over the corporation.

Although many statutes require two-thirds approval for amendment of the certificate,²¹³ the more common pattern is to require approval by a majority of outstanding voting shares.²¹⁴ Amendment of the certificate does not give rise to appraisal rights under most statutes, but some statutes do confer such rights in a limited way—for example, to the holders of shares of a class of stock which is substantially prejudiced by certain types of amendments.²¹⁵

(d) *Voluntary dissolution.*—Under some statutes the shareholders have plenary power over voluntary dissolution. Thus in California 50 percent of the shareholders can dissolve a corporation without any board action,²¹⁶ and in New York and Ohio two-thirds of the shareholders can do so.²¹⁷ But most of the statutes adopt the veto model as the decisionmaking pattern for voluntary dissolution.²¹⁸ Once

213. See the Illinois, Ohio, and Model Business Corporation Act provisions cited in notes 211 and 212 *supra*.

214. See CAL. CORP. CODE § 3632 (West 1955); DEL. GEN. CORP. LAW § 242(d) (1967); N.J. REV. STAT. § 14A:9-2(4) (Supp. 1968); N.Y. BUS. CORP. LAW § 803 (McKinney 1963); PA. STAT. ANN. tit. 15, § 1805 (1967).

215. See OHIO REV. CODE ANN. § 1701.74(A),(B) (Page 1964); *cf.* N.Y. BUS. CORP. LAW § 806(b)(6) (McKinney 1963); PA. STAT. ANN. tit. 15, § 1810 (1967). See also OHIO REV. CODE ANN. § 1701.74(C) (Page 1964) (change in corporate purposes).

216. CAL. CORP. CODE § 4600 (West 1955).

217. N.Y. BUS. CORP. LAW § 1001 (McKinney 1963); OHIO REV. CODE ANN. § 1701.86(E) (Page 1964). The shareholders' power in New York is limited to some extent by their inability to call a special meeting. See note 211 *supra*.

218. DEL. GEN. CORP. LAW § 275 (1967); ILL. ANN. STAT. ch. 32, §§ 157.76(a)-(c) (Smith-Hurd 1954); N.J. REV. STAT. § 14A:12-4 (Supp. 1968); PA. STAT. ANN. tit. 15, § 2102 (1967); ABA MODEL BUS. CORP. ACT ANN. § 77 (1960). All of these statutes except that of Delaware also provide that the shareholders may by unanimous written consent dissolve the corporation without board approval or initiation. ILL. ANN. STAT. ch. 32, § 157.75 (Smith-Hurd 1954); N.J. REV. STAT. 14A:12-3 (Supp. 1968); PA. STAT. ANN. tit. 15, § 2102 (1967); ABA MODEL BUS. CORP. ACT ANN. § 76 (1960). Delaware, which used to have such a provision, dropped it in 1967. Compare [previous] DEL. CODE ANN. tit. 8, § 275(d) (Supp. 1966), with DEL. GEN. CORP. LAW § 275 (1967). However, Delaware has added a section permitting the certificate of a "close corporation" to include "a provision granting to any stockholder, or to the holders of any specified number or percentage of shares of any class of stock, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency." DEL. GEN. CORP. LAW § 355(a) (1967). The statutory definition of "close corporation" is fairly elaborate: Essentially, it is a corporation which has no more than thirty record shareholders, has restricted the transferability of its stock, has not made a public offering within the meaning of the Securities Act, and has stated in its certificate that it is a "close corporation." DEL. GEN. CORP. LAW §§ 342, 343 (1967). Delaware's close-corporation dissolution provision roughly parallels N.Y. BUS. CORP. LAW § 1002 (McKinney 1963).

more, this seems extremely unwise, considering the fact that dissolution normally entails a job loss by management, which is therefore unlikely either to initiate or approve such an action. Under no statute does dissolution give rise to appraisal rights.²¹⁹

2. *The Statutory Coverage*

With few exceptions, then, the decisionmaking pattern of the received legal model turns out to be wholly inaccurate as a descriptive device when matched up against the decisionmaking patterns embodied in the corporate statutes. Furthermore, there is a serious divergence in coverage between that model and the statutes. According to the received legal model, "fundamental" or "major" corporate actions are shareholder matters. However, statutes generally require shareholder approval for matters which are not fundamental in the economic sense. For example, a corporate certificate must often set forth such matters as the corporation's principal place of business in the state,²²⁰ and (a matter which is frequently one of no great import) the corporate name.²²¹ Yet most statutes require shareholder approval for any certificate amendment. Again, the traditional corporate statute requires approval by the shareholders of both constituents to any merger. But if A&P merges with a small grocery chain, the transaction does not seem economically fundamental from A&P's perspective.

Many recent statutory developments have been in the direction of discriminating between those traditional fundamental changes which are economically fundamental and those which are not. Thus Pennsylvania now provides that shareholder approval is not required for a sale of substantially all assets made "for the purpose of relocating the business of the corporation,"²²² while New York provides that the board can make certain "routine" amendments, such as changes in the location of the corporation's office, without shareholder action.²²³ But these examples are relatively isolated.

Typically the statutes require two-thirds approval for dissolution. *See, e.g.*, the Delaware, Illinois, and Model Act provisions cited *supra*. *But see* the Pennsylvania provision cited *supra* (majority vote).

219. *See* Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 250.

220. *See, e.g.*, OHIO REV. CODE ANN. § 1701.04(2) (Page 1964).

221. *See, e.g., id.* § 1701.04(1).

222. PA. STAT. ANN. tit. 15, § 1311(A) (1967), and Historical Note thereto. Some courts have reached a comparable result in the absence of such a provision. *See, e.g.*, *Murphy v. Washington League Baseball Club, Inc.*, 293 F.2d 522 (D.C. Cir. 1961); *Good v. Lackawanna Leather Co.*, 96 N.J. Super. 439, 233 A.2d 201 (1967).

223. N.Y. BUS. CORP. LAW § 803(b)(1) (McKinney 1963), and Revisers' Notes; *cf.* N.J. REV. STAT. § 14A:4-3 (Supp. 1968).

In the area of mergers, however, statutory revision in this direction has been more significant. Within the last several years, Ohio, Delaware, New Jersey, and Pennsylvania have all adopted provisions dispensing with the need for approval by the survivor's shareholders of certain mergers which are not likely to be economically fundamental—not likely to involve structural changes. Under the Ohio statute, adopted in 1963, approval by the survivor's shareholders is not required if the stock issued to the transferor's shareholders carries no more than one-sixth of the voting power existing immediately after the merger, and the merger agreement makes no change in the survivor's certificate or by laws.²²⁴ Under the Delaware statute, adopted in 1967, and the New Jersey and Pennsylvania statutes, adopted in 1968, approval by the survivor's shareholders is not required if the shares of any class of stock to be issued to the transferor's shareholders do not exceed 15 percent of the shares of such class outstanding immediately prior to the merger, and the merger agreement makes no change in the survivor's certificate.²²⁵

These statutes differentiate between mergers according to the proportionate size of the constituents; they may be thought of as small-scale merger statutes. Another type of statute, known as a short- or short-form merger statute, differentiates between mergers according to the amount of stock of one constituent corporation (the subsidiary) held by the other (the parent) immediately prior to the merger. Where the percentage is large enough, a merger can be effected by the sole action of the parent's board: No approval need be obtained from the parent's shareholders, the subsidiary's shareholders, or the subsidiary's board.²²⁶ While some of these statutes are applicable only to cases in which the subsidiary is 100 percent owned

224. OHIO REV. CODE ANN. §§ 1701.79(A)(2)-(6) (Page 1964). Approval by the survivor's shareholders is also required if the survivor's certificate so provides, or if the merger agreement authorizes or effects "any particular corporate action" which otherwise requires shareholder approval. *Id.* §§ 1701.79(A)(1), (7).

The Ohio statute actually uses the terms "articles" and "regulations" rather than the more usual terms "certificate" and "bylaws." However, in order to simplify comparison between statutes, in this article the term "certificate" will include comparable terms such as "articles" or "charter," and the term "bylaws" will include comparable terms such as "regulations."

225. DEL. GEN. CORP. LAW § 251(f) (1967); N.J. REV. STAT. § 14A:10-3(4) (Supp. 1968); Act 216, § 46(A) [1968] Purdon's Pa. Leg. Service 456. Shareholder approval is also required if the certificate so provides, or, in Pennsylvania, if the merger "otherwise affect[s]" the survivor's outstanding shares. These provisions are discussed in more detail in the text accompanying notes 386-400 *infra*.

226. See generally 2 ABA MODEL BUS. CORP. ACT ANN. 345-47 (1960); Note, *Elimination of Minority Share Interest by Merger: A Dissent*, 54 NW. U.L. REV. 629 (1959); Comment, *The Short Merger Statute*, 32 U. CHI. L. REV. 596 (1965).

by the parent,²²⁷ the New York and Model Act provisions apply if the parent owns 95 percent of the subsidiary's stock,²²⁸ and within the last 15 years the percentage required under the Delaware, New Jersey, and Pennsylvania short-form merger statutes was reduced from 100 to 90 percent.²²⁹

Since at least 90 percent of the subsidiary's stock must be held by the parent, the dispensation of approval by the subsidiary's shareholders is of limited importance.²³⁰ The dispensation of approval by the subsidiary's board and the parent's shareholders is more significant. The subsidiary's board would be bound by its fiduciary responsibility to exercise an independent judgment, and therefore in theory might reject the merger. So might the parent's shareholders, unless it is assumed that the terms of such mergers will always be so favorable to the parent that the parent's shareholders would never reject them—an assumption which implies a corresponding disfavoring of the subsidiary's shareholders. A more acceptable rationale might be that shareholder approval need not be required in the case of a corporation which is not issuing a significant amount of stock or undergoing any other substantial change—in other words, a rationale similar to that which apparently underlies the small-scale merger statutes.²³¹

227. See, e.g., CAL. CORP. CODE § 4124 (West 1955); OHIO REV. CODE ANN. § 1701.831 (Page Supp. 1966).

228. N.Y. BUS. CORP. LAW § 905 (McKinney 1963), as amended. (McKinney Supp. 1967); ABA MODEL BUS. CORP. ACT ANN. § 68A (1960).

229. See *Coyne v. Park & Tilford Distillers Corp.*, 38 Del. Ch. 514, 515, 154 A.2d 893, 894 (Sup. Ct. 1958); DEL. GEN. CORP. LAW § 253 (1967); N.J. REV. STAT. § 14A:10-5 (Supp. 1968); Act 216, § 46(A) [1968] Purdon's Pa. Leg. Service 455-56 and note thereto. The Pennsylvania statute only dispenses with the requirement of approval by the parent's shareholders, retaining the requirement that the merger be approved by the subsidiary's shareholders and board.

230. See *Johnstone & Galloway, Mergers, Consolidations and Asset Sales*, 15 S.C.L. REV. 415, 419 (1963); 2 MODEL BUS. CORP. ACT ANN. 348 (1960).

231. Such a rationale would fit short-form mergers only if the statutes were inapplicable to mergers which effect significant legal changes in the parent; but generally speaking, that is the case. A substantial change in the parent might be accomplished through a downstream merger—that is, a merger of the parent into the subsidiary, in which the subsidiary survives and the effect of the transaction is therefore to substitute its certificate for the parent's—or through a merger plan which makes a direct change in the parent's certificate. Most of those statutes under direct consideration which permit short-form mergers, with the possible exception of those of Delaware and New York, contain language making it more or less clear that they either cannot be used for a downstream merger or cannot be used for a merger which involves any change in the parent's certificate. See CAL. CORP. CODE § 4124 (West 1955); OHIO REV. CODE ANN. § 1701.831(a) (Page Supp. 1966); N.J. REV. STAT. § 14A:10-5(6) (Supp. 1968); Act 216, § 46(A) [1968] Purdon's Pa. Leg. Service 455-56; ABA MODEL BUS. CORP. ACT ANN. § 68A (1960), and annot. 4 thereto ("a merger under section 68A should not materially affect" the rights of the parent's shareholders). The Ohio short-form statute is inapplicable not only to mergers involving a change in the parent's certificate but to mergers involving a change in its

While the traditional corporate statutes do require shareholder approval for many actions which are not economically fundamental or structural, they fail to cover a number of corporate actions which are. For example, where Corporation *A* acquires 100 percent of the stock of Corporation *B* in exchange for its own stock, and *B* is relatively large in proportion to *A*, or where Corporation *C*, composed of two businesses equal in size, sells one and distributes the proceeds, thus effectively contracting its size by 50 percent, the transactions seem economically fundamental or structural. Yet the traditional statutes do not explicitly cover either of such transactions. These examples are instances of two important classes of actions, not generally covered by the corporate statutes, which might be called the modern fundamental changes: corporate combinations other than those denominated as mergers, and corporate divisions. Before turning to the problems raised by these classes of corporate action, it is necessary to round out the normative models of the corporation by examining the place of the appraisal right in those models.

D. The Place of the Appraisal Right in a Normative Corporate Model

In reviewing the statutory patterns governing the traditional fundamental changes, we saw that in many cases the statutes confer upon a shareholder the right to require the corporation to purchase his shares at an appraised price if it undertakes certain kinds of actions from which he dissents. If the corporate form of organization is viewed through the prism of any other form of business organization, this right must seem very unusual. Moreover, as already noted, no such right is reflected in the received legal model of the corporation. Is the appraisal right then aberrational, or does it have a place in a normative model of the corporation?

bylaws. The Delaware short-form provision is applicable to downstream mergers, DEL. GEN. CORP. LAW § 251(c) (1967). The Delaware provision is inapplicable to "any merger which effects any changes other than those herein specifically authorized with respect to the parent corporation," DEL. GEN. CORP. LAW § 253(c) (1967), but it is not completely clear what changes are "herein specifically authorized," cf. *Havender v. Federal United Corp.*, 24 Del. Ch. 318, 326-29, 11 A.2d 331, 335-36 (Sup. Ct. 1940), since the provision specifically permits downstreams and provides that where the subsidiary is not wholly owned "the resolution of the [parent's] board . . . shall state the terms and conditions of the merger." DEL. GEN. CORP. LAW § 253(a) (1967). The New York short-form provision is inapplicable to downstream mergers, but provides that the merger plan may contain "such other provisions with respect to the proposed merger as the [parent's] board considers necessary or desirable." N.Y. BUS. CORP. LAW § 905(a)(4) (McKinney 1963). However, this apparently broad grant of power may and probably would be subject to an implied limitation that it not be used to effectuate a significant change in the parent's certificate without shareholder approval. See text accompanying notes 434-47 *infra*.

Within the last few years, the view seems to have been growing that it does not. For example, at one time the all but universal practice was to give appraisal rights to the shareholders of each constituent to any merger. However, within the last few years Ohio and Delaware have eliminated the appraisal right of the survivor's shareholders in those small-scale mergers which do not require approval of the survivor's shareholders,²³² Delaware has eliminated the appraisal right as to any stock which is part of a class registered on a national securities exchange or held of record by not less than 2000 shareholders,²³³ and New Jersey has eliminated it as to any stock which is part of a class listed on a national securities exchange or regularly quoted on the over-the-counter market by one or more members of a national or affiliated securities association.²³⁴ In large part, the assault on the appraisal right has found its intellectual justification in an extensive critique of the right by Dean Manning.²³⁵ An examination of this critique will provide a starting point for analysis of whether the appraisal right does indeed have a place in a normative model, and if so, what that place should be.

The thrust of Dean Manning's critique of the appraisal right is twofold: that it ill-serves the shareholder who uses it, and ill-serves the corporation against which it is asserted.²³⁶ On the shareholder side Manning notes that the procedure the shareholder must follow is highly technical, long, and expensive; that if the corporation's stock is publicly traded, the courts will not go beyond an inquiry into market price (a proposition which the cases do not fully support),²³⁷ while if it is not publicly traded the amount of the award is unpredictable; and that when the award is finally made it will be taxable, whereas the

232. DEL. GEN. CORP. LAW § 262(k) (1967); OHIO REV. CODE ANN. § 1701.81(B) (1964).

233. DEL. GEN. CORP. LAW § 262(k) (1967).

234. N.J. REV. STAT. § 14A: 11-1 (Supp. 1968).

235. Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34; *see, e.g.*, Folk, *De Facto Mergers in Delaware: Hariton v. Arco Electronics, Inc.*, 49 VA. L. REV. 1261 (1963); McDonough, *The Appraisal Remedy for Dissenting Shareholders in Iowa and the De Facto Merger Doctrine: Rath v. Rath Packing Company*, 16 DRAKE L. REV. 22 (1966).

236. Manning actually begins his critique with another point—that the presence of the appraisal remedy has often influenced the courts to cut down the availability, or even preclude the granting, of other types of relief, particularly injunctive relief based on unfairness. The true extent of this tendency is very difficult to determine, *see* Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964), but in any event the problem is not intrinsic to the appraisal remedy and is therefore legislatively remediable. *Cf.* Lattin, *A Reappraisal of Appraisal Statutes*, 38 MICH. L. REV. 1165 (1940).

237. *See In re Kaufman, Alsborg & Co.*, 30 Misc. 2d 1025, 1030-31, 220 N.Y.S.2d 151, 158 (Sup. Ct. 1961), *aff'd per curiam*, 15 App. Div. 2d 468, 222 N.Y.S.2d 305 (1961). *See also In re Olivetti Underwood Co.*, 246 A.2d 800 (Del. Ch. 1968).

transaction dissented from may very well have produced tax-free benefits to the shareholder. Generally speaking, these criticisms are accurate, although many of them are equally applicable to many other legal rights which must be asserted through litigation. However, they are hardly dispositive, because in themselves they indicate not that the remedy is unsound, but merely that its usefulness, like the usefulness of all legal rights, may be limited by the boundaries of reality and legislative drafting.

But when he turns to the effect of the appraisal right on the corporation, Manning does conjure up problems intended to bring the very soundness of the right into question. First, he argues that the assertion of appraisal rights may wipe out the enterprise.

Even a relatively modest number of shareholders claiming the appraisal remedy may constitute a severe economic threat to the corporate enterprise. . . . If some shareholders go the appraisal road, a sudden and largely unpredictable drain is imposed upon the corporation's cash position. This demand for a cash pay-out to shareholders often comes at a time when the enterprise is in need of every liquid dollar it can put its hands on.

Some kind of corporate surgery is going on; the enterprise is much more apt to be in need of a blood transfusion than a leeching. . . . [T]he period following the closing will likely be a period of intense activity as a general reshuffling takes place in the administrative, productive, and distributional arrangements of the combined enterprise. The management hopes that in time these steps will prove economic; but in the short run many of them will require a cash in-put.²³⁸

The gravity of the "threat to the corporate enterprise" seems highly exaggerated. No evidence is adduced that corporations involved in mergers are "in need of a blood transfusion," and my own observation has been that most mergers involve two perfectly healthy enterprises. Even then, of course, there may be a short-run cash output, but it is unlikely to be material in terms of cash resources. Furthermore, in considering the appraisal right from the shareholder's point of view, Manning stresses that the procedure by which the right must be asserted is a long and weary one. If that is so, then by the time a dissenter is actually paid off the short-run period of adjustment will be far behind.

Second, Manning argues that the payments made to dissenters may lead creditors to start a run on the corporation's treasury.

238. Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 234.

This may be a time, too, when uneasy trade creditors, suppliers, or banks may decide that they would be happier to have cash in their pockets rather than a claim against the still untried combined enterprise. The creditor of Corporation A suddenly finds an unknown horde of creditors of Corporation B standing equally beside him, and, typically, he knows little or nothing about the amount of liquidity of the assets that Corporation B has brought to the marriage. The creditors of Corporation B feel the same apprehension about Corporation A. Both are inclined to get a little itchy for cash. When, at precisely the wrong psychological moment, the corporation ladles out a dollop of dollars to its shareholders under the appraisal statutes, the reaction of creditors may be one of consternation and the run begins.²³⁹

Again, no evidence is adduced, and again my own observation has been that while the "trade creditors, suppliers, [and] banks" are indeed at the door following a merger, they are kneeling, not pounding. Their object is not to get out, but to get in—at best, to garner all the business of the reconstituted enterprise, at worst, to retain the business they had. Furthermore, the time when payment must actually be made to dissenting shareholders will, as Manning's earlier point emphasizes, lie in the dim, distant future.

Finally, Manning argues that the uncertainty as to how many shareholders will dissent may itself raise serious problems.

Even though the company may be economically very strong, it may not be able to go ahead with the merger at all if the aggregated claim of dissenting shareholders under the appraisal statutes comes to a high figure. This means that for purposes of planning its course of action, and deciding whether to go ahead with the merger, the management needs to know as soon as possible what the total cash demand is likely to be. And here is the rub. The answer obviously depends upon the claim procedure prescribed in the appraisal statute. But under the procedures of many of the statutes, claimants are not required to file their claims until some time after the merger. The situation is both circular and dangerous.²⁴⁰

In practice, however, this potential uncertainty hardly ever turns out to be a real problem, because if the situation is threatening, the lawyers will insert in the relevant agreement a provision allowing one or both sides to back off prior to the closing if too many shareholders dissent.²⁴¹

239. *Id.*

240. *Id.* at 235.

241. Manning states that these provisions "[Do] not fully solve the problem. They introduce an extraneous element of contingency into the transaction. They impose a severe

Following this criticism of the way in which the appraisal right operates, Manning turns to a critical analysis of the types of transactions that give rise to the appraisal right in the first place—"triggering transactions," as he aptly calls them. For purposes of this analysis, Manning sets forth a number of transactions grouped into several lists and asks why some of them are triggering transactions while others are not. Thus the first list includes, among other things, a "Presidential heart attack" and "large scale disarmament."²⁴² Manning notes that the usual answer given to the question why events like these are not triggering transactions is that they are not brought about by the will of the majority. But, he says, this explanation is unsatisfactory, "for it leaves open the question: Why are we interested in protecting the investor against internal risks only?"²⁴³

Now it will be noted that this last point shifts the argument radically, although almost unnoticeably, from the original question (Why should the shareholder be protected only against events brought

bargaining disadvantage where only one of the participating companies thinks that it has a substantial number of potential dissenters: the shareholders and management of the unanimous company are not apt to be happy at seeing *their* cash siphoned off to shareholders of the other corporation immediately after the merger. Under some of the corporation statutes there are legitimate questions about the legal authority of the directors to move even under these contractual provisions.

"The availability of the kick-out tends to poison the whole atmosphere of the negotiation and to expose other terms of the transaction to continuous redickering. . . .

"It is not easy to ask the shareholders to approve an 'iffy' merger. It is not necessarily politic to explain all the implications of the kick-out clause in the proxy statement—and it may be dangerous to explain too little. The situation is prickly all around." Manning, *The Shareholder's Appraisal Remedy*, *supra* note 87, at 237-38.

Again, these problems are exaggerated. Such provisions seldom pose "a severe bargaining disadvantage," because normally agreements are negotiated on the premise that mass dissent will not take place. Such provisions are common, and there is no evidence that they "poison the whole atmosphere of the negotiation" or "expose other terms of the transaction to continuous redickering." Nor is there any evidence that corporations have the slightest hesitation in either asking or getting shareholders to approve agreements containing such a provision. Finally, the likelihood that such provisions are invalid is minimal. They appear to be permissible even in the absence of statutory provision. See *Hoit v. American Bantam Car Co.*, 69 F. Supp. 731, 734 (W.D. Pa. 1947); *Zobel v. American Locomotive Co.*, 182 Misc. 323, 327-28, 44 N.Y.S.2d 33, 37 (Sup. Ct. 1943); Fuld, *Some Practical Aspects of a Merger*, 60 HARV. L. REV. 1092, 1094-99 (1947); *cf. In re McKinney*, 306 N.Y. 207, 117 N.E.2d 256 (1954). In any event, modern statutes commonly include provisions which give the board either absolute power to abandon a merger, see CAL. CORP. CODE § 4112 (West 1955), or power to abandon a merger if so authorized by the merger plan, see, e.g., DEL. GEN. CORP. LAW § 251(d) (1967); ILL. ANN. STAT. ch. 32, § 157.61(e) (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 903(b) (McKinney 1963); OHIO REV. CODE ANN. § 1701.78(C) (4) (Page 1964); Act 216, § 45(C) [!1968] Purdon's Pa. Leg. Service 455; ABA MODEL BUS. CORP. ACT ANN. § 67 (1960). See generally Note, *Withdrawal of Fundamental Changes Before a Vote, an Unrecognized Compliment to Abandonment—A Proposed Change in Ohio's Abandonment Statute*, 32 U. CIN. L. REV. 380 (1963).

242. Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 241.

243. *Id.* at 242.

by the majority?) to a new question: Why should the shareholder be protected "against internal risks only"? The two questions are very different, for a risk may be "internal" and yet not shareholder-created. Having so shifted the argument, Manning then develops a second list which consists of just such internal but nonshareholder-created events—for example, "a demand by the relevant unions for higher wages, accompanied by strike threat" and "a refusal by important suppliers to continue to supply the company."²⁴⁴ Since these events are not triggering transactions, and since, he says, "[to] limit statutory concern to shareholders' and directors' acts is wholly arbitrary," Manning concludes that it is "apparent that we are not dealing with an economic problem . . . [since] the economic risk to the shareholder does not turn on the question of who was responsible for the event giving rise to the risks"; and he attempts to bolster this conclusion by asserting that the statutes "do not make the differentiation [between triggering and nontriggering transactions] in economic categories, but in lawyer's categories."²⁴⁵ Now the fact that the appraisal right is not triggered by all economic risks in no way shows that the right is not intended to deal with an economic problem; and, as we shall show below, the fact that the appraisal right is triggered only by actions effected by majority shareholders is not in the least bit arbitrary. But is Manning correct in asserting that the statutory differentiations between triggering and nontriggering transactions do not correspond to economic categories?

To support this assertion Manning develops an argument based on the theory that the crucial triggering transaction (at least from the point of view of understanding appraisal) is the merger, and that the reasons for giving appraisal rights in the case of merger are grounded in ideology and constitutional principles, rather than economics:

To the nineteenth-century mind . . . a corporate merger . . . involved a species of corporate assassination. . . . A three-dimensional thing, created by the sovereign legislature, had passed away. . . . But something else happened, too. The shareholders of Corporation A somehow became shareholders of Corporation B and no longer shareholders of Corporation A. The mere statement of such a preposterous proposition did violence to fundamental principles. How *could* a man who owned a horse suddenly find that he owned a cow? Furthermore—or perhaps this is but another statement of the same point—even if this transaction could somehow be brought off, surely

244. *Id.*

245. *Id.*

it could not constitutionally be done without the owner's consent. . . .

. . . .

. . . When commercial pressures forced the enactment of the general merger statutes, the function of the appraisal statutes was clear. They met a conceptual and ideological problem—how to preserve the constitutionality of the merger statutes. The appraisal provisions were calculated to solve a purely conceptual need—to provide something for the shareholder who was about to undergo a *legal trauma*²⁴⁶

This thesis is open to question on at least three grounds:

(1) It has already been seen that the changes which require shareholder approval under the traditional statutes are not coextensive with the changes we have labeled structural in the normative model. Nevertheless, when the normative model is laid alongside the traditional statutes, a strong structural motif becomes visible. It is true that at first glance this structural motif appears to relate, as Manning argues, to changes in the legal structure of the corporation (that is, changes in the corporate entity), rather than changes in the economic structure of the corporation (that is, changes in the corporate enterprise). Viewing the traditional fundamental changes in this light, it could indeed be concluded that the traditional statutes require shareholder approval for mergers and certificate amendments only because they involve rearrangement of the legal structure, for dissolution only because it involves termination of the legal structure, and for the sale of substantially all assets because it involves a *de facto* amendment of the certificate. So viewed, the corporate statutes would indeed seem based on economically irrelevant criteria.

But the statutes can also be viewed in another light. It is possible that the purpose of the statutes was to govern structural changes in the enterprise, and that they dealt in terms with changes in the legal structure only because such changes provided a convenient and readily identifiable handle for latching on to changes in the enterprise.²⁴⁷ Thus the statutes may have required shareholder approval for mergers, as a way of governing the restructuring of the enterprise through a combination; for certificate amendment, as a way of governing changes in the relative rights of shareholders and in the purpose of the enterprise; for dissolution, as a way of governing termination of the structure of the enterprise;²⁴⁸ and for sale of substantially all assets,

246. *Id.* at 246-47.

247. *Cf.* Note, 107 U. PA. L. REV. 420, 424 (1959).

248. *Cf. Doe Run Lead Co. v. Maynard*, 283 Mo. 646, 685, 223 S.W. 600, 611 (1920).

as a way of governing certain transformations in the nature of the enterprise's assets.²⁴⁹ If today the corporate statutes fail to deal with many types of structural changes in the enterprise, that was not necessarily true of the statutes when they were enacted. For example, if the statutes as enacted failed to deal with business combinations effected through an acquisition of stock, that may have been because at early common law the power of one corporation to hold stock in another was quite doubtful,²⁵⁰ so that such acquisitions were uncommon. If the statutes when enacted failed to deal with corporate separations (that is, the transfer by a corporation of one of several businesses), that may have been because in the early days of corporate law most corporations were, by law or custom, single-purpose²⁵¹ so that a corporate separation was an anomaly. It may be surmised that the enacting legislatures felt that as new types of structural changes in corporate enterprise evolved or assumed significance, statutory changes would follow. Undoubtedly, modern legislatures have been remiss in their handling of corporate problems; but we must distinguish between the corporate statutes as they look to us today, and the statutes as they looked to those who enacted them.

(2) Manning's argument that appraisal rights have a constitutional genesis is at best a minority view. Most commentators hold the opinion that the legislatures conferred appraisal rights on dissenting shareholders as a matter of fairness, not as a matter of constitutional compulsion.²⁵² Ballantine seems to have gone about as far as one may fairly go on the basis of existing evidence when he said that "It is not easy to ascertain whether this remedy . . . is intended for the benefit and protection of the minority or for the benefit of the majority to remove any doubt about the constitutionality of fundamental changes without unanimous consent."²⁵³

(3) Finally, and most important, if we look at the statutes as a

249. This is not to say that the statutory solutions were the correct ones—we shall discuss that question in Part II—but only that they may have had an economic thrust despite their legalistic cast.

250. See note 528 *infra*.

251. E. LATTY & G. FRAMPTON, BASIC BUSINESS ASSOCIATIONS CASES, TEXT AND PROBLEMS 312 (1963); A.A. Berle, *Economic Power in A Free Society*, in THE CORPORATION TAKE-OVER 86, 88 (A. Hacker ed. 1965).

252. See, e.g., Levy, *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 CORNELL L.Q. 420-21 (1930); Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547 (1927); cf. *Chicago Corp. v. Munds*, 20 Del. Ch. 142, 149, 172 A. 452, 455 (Ch. 1934). A constitutional origin does seem possible in Pennsylvania, cf. *Lauman v. Lebanon Valley R.R.*, 30 Pa. 42 (1858).

253. Ballantine, *Questions of Policy in Drafting a Modern Corporation Law*, 19 CALIF. L. REV. 465, 482 (1931).

whole, rather than looking only at the merger provisions, Manning's thesis—that the appraisal right is based on ideological and constitutional principles, not on economics—turns out to be wholly inconsistent with the statutes it purports to explain. If Manning's thesis is correct, it should follow that: (1) A merger would not trigger appraisal rights for the survivor's shareholders, since the entity of the survivor need not be affected by a merger, and the only necessary effect of a merger on such shareholders is an economic one; (2) An amendment of the certificate of incorporation should normally trigger appraisal rights, since it involves a change in the entity; (3) Dissolution should trigger appraisal rights for the same reason; (4) A sale of all assets should not trigger appraisal rights, since it does not affect the entity, and its only effect on the survivor's shareholders is an economic one.

The hard facts, however, are that in each case just the contrary is true: (1) A merger normally triggers appraisal rights for the survivor's shareholders; (2) Amendment of the certificate usually does not trigger appraisal rights; (3) Dissolution never triggers appraisal rights; (4) A sale of substantially all assets usually does trigger appraisal rights.²⁵⁴

But assuming that Manning's specific criticisms are not wellfounded, we are still left with the larger question he raises: Is the appraisal right desirable? Does it have any real utility? Again, it is necessary to separate out privately and publicly held corporations.

1. Privately Held Corporations

To understand the real utility—and probably the real origin—of the appraisal right in the privately held corporation, we must once more go back to the partnership form. It will be recalled that absent contrary agreement decisions outside the scope of the partnership business can be made only by unanimous consent, new partners cannot be admitted without unanimous consent, and partnerships are normally short-lived and always easy to dissolve. These three partnership incidents, apparently disparate, are actually complementary. The absolute veto of each partner in matters outside the scope of the partnership business seriously restricts his copartners' freedom of action. This restriction might be intolerable, except for the fact that each partner has agreed to the identity of his fellow veto-bearers, and that in any event the timespan of the veto is ordinarily not a long one since the remaining partners can either dissolve the

254. See note 369 *infra*.

partnership or await the end of its term and then reform the enterprise along the desired lines.

But the corporation presents a very different face. Neither of the conditions making a veto tolerable in the partnership is normally present in the corporation: Duration is normally perpetual, and the identity of fellow shareholders is not necessarily within a shareholder's control. For these reasons, absent contrary agreement, a majority, or at least a two-thirds majority, should be able to make structural changes in the corporation even over the objection of minority shareholders. But just as the veto power might be intolerable in the corporation, so might be an unrestricted power in the majority to make structural economic changes unless some method was provided whereby minority shareholders would not be locked into the restructured enterprise over their objections. The minority, in other words, should have the right to say to the majority: "We recognize your right to restructure the enterprise, provided you are willing to buy us out at a fair price if we object to the new structure so that we are not forced to participate in an enterprise other than the one contemplated at the outset." In short, at least in the context of the privately held corporation, the appraisal right is a mechanism admirably suited to reconcile the need to give the majority members of a normally perpetual organization the right to make drastic changes in the enterprise to meet new conditions as they arise with the need in such an organization to prevent the minority from being involuntarily dragged along into a drastically changed enterprise in which it has no confidence.

This rationale does not explain all the legislative variations in appraisal rights, but it explains a good many. It explains, for example, why events not precipitated by majority shareholders—whether external, such as large scale disarmament, or internal, such as a strike—do not trigger appraisal rights. It explains why the shareholders of the survivor in a merger usually have appraisal rights: A merger normally involves a restructuring of the survivor's enterprise even though it does not involve a restructuring of the survivor's entity.²⁵⁵ It explains why a sale of substantially all assets usually triggers

255. This interpretation does not fully explain why certificate amendments usually do not trigger appraisal, since a change in the relative rights of shareholders can have drastic economic effects. Perhaps the reason is that the statutes, when drafted, were premised on a simple stock structure, or were oriented toward the needs of common shareholders. In any event, some important statutes, including those of New York and Ohio, do provide that certain kinds of certificate amendments trigger appraisal rights, see Note 215 *supra*, and usually these statutes turn on the *economic* effect of the amendment, such as whether it works substantial adverse effect on the class of stock held by the dissenter.

appraisal rights: The transaction invariably involves a complete restructuring of the nature of the seller's assets. Finally, it explains why dissolution does not trigger appraisal rights: In a dissolution everybody is getting out, and the minority shareholder does not need the protection of a mechanism which is designed to protect him against being locked into a restructured continuing enterprise.

In the case of a privately held corporation, therefore, the appraisal right falls naturally into place to complete a normative model of decisionmaking.²⁵⁶ But it should be noted that the appraisal right need not invariably accompany the voting right since the appraisal right should normally be available in the privately held corporation only in the case of a drastic restructuring of a continuing enterprise, while the voting right may be appropriate in some cases where the restructuring is less than drastic or the enterprise does not continue. Some cases where only one of the two rights seem appropriate will be explored in Part II.

2. Publicly Held Corporations

Absent special agreement, a shareholder in a privately held corporation ordinarily cannot withdraw from the enterprise unless he has an appraisal right: Either there will be no market at all for such shares, or the market will be too thin to be relied on. Since a shareholder in a publicly held corporation normally can withdraw by selling his shares on the market, his need for an appraisal right is certainly less compelling, as Manning has argued.²⁵⁷ Furthermore, the expectations of many shareholders in publicly held corporations undoubtedly revolve around the market rather than the enterprise in any event.²⁵⁸ Should the appraisal right therefore be eliminated in the case of publicly held corporations?

An initial problem would be to define publicly held corporations for these purposes. We have already seen the definitional difficulties raised by voting rights.²⁵⁹ However, the voting rights problem is essentially one of measuring expectations, and the difficulty there arises in part from the fact that expectations cannot be easily quantified. The appraisal problem, on the other hand, may be viewed in terms of the marketability of a corporation's stock, rather than in terms of the expectations of its shareholders. Thus for appraisal

256. Cf. Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1295; 51 *LA. L. REV.* 1096, 1101 (1966).

257. See Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 261.

258. See text accompanying notes 89-163 *supra*.

259. See text accompanying notes 167-69 *supra*.

purposes a publicly held corporation might be viewed as one whose stock is traded on a market which provides a ready means for dissatisfied shareholders to dispose of their stock at a fair price. This definition, in turn, is susceptible of quantification. For example, such a market might be deemed to exist in the case of stock listed on the New York or American Stock Exchanges, or held by some minimum number of shareholders, say 1000-2000. This approach was taken by the 1967 Delaware statute, which cut off appraisal rights in the case of stock held of record by 2000 shareholders or listed on a "national securities exchange."²⁶⁰ The latter provision is, however, ambiguous, since a number of exchanges (such as the Pacific Coast, Philadelphia-Washington-Baltimore, and Boston) are sometimes referred to as "national" because they are registered under the Securities Exchange Act of 1934, and at other times are referred to as "regional" because unlike the New York and American Exchanges, they are not economically national.²⁶¹ If the statute was intended to include these exchanges it achieves an unfortunate result, because they may provide a relatively thin market which is incapable of absorbing a significant amount of stock at a fair price. Even more unfortunate is the 1968 New Jersey statute, which denies appraisal rights whenever the stock in question is regularly quoted by even a single member of a national securities association.²⁶² Such quotations may be made on the basis of an extremely small amount of stock actually available for trading, and in such cases there would be little likelihood that a significant amount of stock could be disposed of at a fair price.

A second hurdle is not so easily leaped. While it is true that many shareholders in publicly-held corporations are market-oriented, it has already been seen that many others are likely to own an amount of stock sufficient to orient their expectations around the long-term prospects of the enterprise rather than around a market which tends to fluctuate severely over any given short-run period. It may be

260. DEL. GEN. CORP. LAW § 262(k) (1967).

261. See Securities Exchange Act §§ 5, 6, 15 U.S.C. § 78(e), (f) (1964); 33rd SEC ANNUAL REPORT 55, 57 (1968). Professor Folk, who was official reporter to the Delaware Corporation Law Revision Commission, has published a pamphlet on the new Delaware act, but his comment on the appraisal section does not resolve the critical ambiguity.

"The new statute also eliminates cash appraisal rights in two other situations. First, there is no appraisal right with respect to shares of any class of stock listed on a national securities exchange, such as the New York or American Stock Exchanges." I. FOLK, THE NEW DELAWARE CORPORATION LAW 37 (1967). However, a booklet by a member of the Committee and a member of its legal staff states that "The term 'national securities exchange' means a stock exchange which is registered under the Securities Exchange Act of 1934." A. ARSHT & W. STAPLETON, ANALYSIS OF THE NEW DELAWARE CORPORATION LAW 340 (1967).

262. N.J. REV. STAT. § 14A:11-1 (Supp. 1968).

questioned whether such shareholders should be remitted to the market to find relief from structural changes to which they object, unless the market to which they are remitted is not only continuous and deep, but is likely to reflect fairly the value of the enterprise. It seems clear, however, that the stock markets as presently constituted do not serve that function. As the Delaware Chancery court itself has pointed out:

When it is said that the appraisal which the market puts upon the value of the stock of an active corporation as evidenced by its daily quotations, is an accurate, fair reflection of its intrinsic value, no more than a moment's reflection is needed to refute it. There are too many accidental circumstances entering into the making of market prices to admit them as sure and exclusive reflectors of fair value. The experience of recent years is enough to convince the most casual observer that the market in its appraisal of values must have been woefully wrong in its estimates at one time or another within the interval of a space of time so brief that fundamental conditions could not possibly have become so altered as to affect true worth. Markets are known to gyrate in a single day. The numerous causes that contribute to their nervous leaps from dejected melancholy to exhilarated enthusiasm and then back again from joy to grief, need not be reviewed. It would be most unfortunate indeed either for the consolidated corporation or for the objecting shareholder if, on the particular date named by the statute for the valuation of the dissenter's stock, viz., the date of the consolidation, the market should be in one of its extreme moods and the stock had to be paid for at the price fixed by the quotations of that day. Even when conditions are normal and no economic forces are at work unduly to exalt or depress the financial hopes of man, market quotations are not safe to accept as unerring expressions of value. The relation of supply to demand on a given day as truly affects the market value of a stock as it does of a commodity; and temporary supply and demand are in turn affected by numerous circumstances which are wholly disconnected from considerations having to do with the stock's inherent worth.²⁶³

That was written in 1934, but things have not changed much, in this regard, since then. To give a random illustration, the following are the highs and lows for 1968 among the first ten stocks, alphabetically, on the New York Stock Exchange, as recorded in the New York Times at hand as this passage is written (that of September 4, 1968):

263. *Chicago Corp. v. Munds*, 20 Del. Ch. 143, 150-51, 172 A. 452, 455 (Ch. 1934).

<i>Corporation</i>	<i>High</i>	<i>Low</i> ²⁶⁴
Abacus	17¾	15½
Abbott Lab	66⅞	41⅞
Abex Co.	42½	28
ACF Ind.	68⅞	39½
Acme Mkt.	44	36
Adam Ex.	18⅞	16
Ad Millis	30⅞	18¾
Address	91½	52
Admiral	25½	16½
Aeroquip	77	47¼

When fluctuations like these occur within a mere eight-month period, it seems arbitrary, to say the least, to remit an enterprise-oriented shareholder to the market for relief, let alone to an over-the-counter market as does the New Jersey statute.²⁶⁵

Furthermore, even assuming that the market fairly reflects the value of the stock in question in its normal operations, remitting a dissenting shareholder to the market will fail to adequately protect him where (1) his block is so large that the mere act of selling the block will depress the market—and it has already been seen that large blocks are common even in stock listed on the New York Stock Exchange—or (2) the very effect of the structural change, when it is announced, is to depress the market price, because the change is an ill-considered one. In other words, even in a well-functioning market, remitting the dissenting shareholder to the market place will be unsatisfactory in just those cases where the shareholder would seem most entitled to appraisal—where his shareholding is a large one, so that his expectations are likely to be oriented around the enterprise rather than the market, or where the structural change is ill-considered, so that the market price after the change is announced is lower than that prevailing before the announcement.

A final problem with eliminating appraisal rights in publicly held corporations is that in such corporations the appraisal right not only serves the function of permitting shareholders to withdraw under certain circumstances at a fair price, but also serves as a check on management. Granted that a certain proportion of shareholders in publicly held corporations will vote in favor of any management proposal, no matter how ill-conceived, and granted that management is not necessarily either highly skilled or disinterested in the making of structural changes, it may be appropriate to structure the decisionmaking process in publicly held corporations so that more

264. N.Y. Times, September 4, 1968, at 60, col. 2.

265. This analysis is inapplicable where the appraisal statute provides only for payment of market value to the dissenter.

than a bare majority or even a two-thirds majority is needed to carry management's decision. As Professor Folk has pointed out:

[I]t is important to maintain some internal or external control to offset the power of the directors, unless one assumes that directors, especially when backed by a shareholder majority, should have unrestrained discretion. Appraisal rights . . . have, in the past, served as a countervailing power to force the insiders to tailor their plans to minimize the number of dissenters by getting the best deal possible. A high vote requirement (including a class vote) plays the same sort of role. When either weapon is removed, the insiders lack the real self-interest to fashion a plan acceptable to a sufficient number of shareholders.²⁶⁶

It has already been seen that the appraisal right presents many difficulties from the shareholder's perspective: It is always technical; it may be expensive; it is uncertain in result, and, in the case of a publicly held corporation, is unlikely to produce a better result than could have been obtained on the market; and the ultimate award is taxable. It is, in short, a remedy of desperation—generally speaking, no shareholder in a publicly held corporation who is in his right mind will invoke the appraisal right unless he feels that the change from which he dissents is shockingly improvident and that the fair value of his shares before the change will far exceed the value of his shares after the change.²⁶⁷ But may not the existence of just such a right—a

266. Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1293.

267. Manning states that: "[T]here is a . . . species of professional shareholder-at-large [who] . . . sees in the appraisal statutes a jimmy that will open windows. The professional shareholder can use the appraisal statute to give mechanical advantage to his relatively small share holdings. He can abuse the procedural process under the appraisal statute to the cost and disruption of the enterprise. He can also, especially where management is concerned about the company's cash position or is anxious that the number of dissenters not grow great enough to trigger a kick-out clause in a merger agreement, use his marginal swing position in an attempt to make a side deal for himself in exchange for not dissenting. His tactic will usually be to vote 'no' to the transaction, wait until the last minute for filing his claim, and hope that circumstances will give him stick-up power." Manning, *The Shareholder's Appraisal Remedy* *supra* note 34, at 238.

Once more this seems exaggerated. How likely is it that a "side deal" will be made? Why should the corporation give this fellow any premium of any kind? This is not like the so-called strike suit, where the shareholder has information relating to individual managers which management is anxious to conceal, and where a side deal using corporate funds for personal objectives is not wholly unlikely. Of course, the scoundrel-shareholder has some leverage, in that if he dissents the corporation will incur expenses; but the scoundrel-shareholder will incur comparable expenses, and will be less able to afford them. Furthermore, he takes a risk that he will end up with an award that may be less valuable than what he would have gotten had he not dissented, *see In re Olivetti Underwood Corp.*, ____ Del. Ch. ____ 246 A.2d 800 (Ch. 1968), and

switch which will be pulled only in case of emergency—be desirable in connection with transactions of the utmost gravity, in which self-interest and lack of investment skills may seriously obscure management's vision?

In short, while it would not be irrational to eliminate appraisal rights as to shares which are traded under conditions which are likely to insure the existence of a continuous and relatively deep market, it seems more advisable to retain the appraisal right even in such cases, partly to protect the fair expectations of those shareholders whose legitimate expectations center on the enterprise rather than on the market, and partly to serve as a well-designed emergency switch to check management improvidence.

II

THE MODERN FUNDAMENTAL CHANGES: VOTING AND APPRAISAL RIGHTS IN CORPORATE COMBINATIONS AND DIVISIONS

A. Legal Principles Governing the Distribution of Power Between Management and Shareholders When the Corporate Statutes Are Silent

We shall turn now to two important classes of corporate actions which are usually not explicitly covered by the corporate statutes: corporate combinations other than those denominated mergers, and corporate divisions. A transaction not explicitly covered by the statutes can be analyzed under two different approaches, which may yield conflicting results. The first approach is to try to squeeze the transaction into the statutory mold, despite the fact the statute does not really cover it, by analyzing the transaction in terms of the categories which the statute does set forth. The result is likely to resemble Hardy in Laurel's dinner jacket. The second approach is to recognize frankly that the statute was not intended to cover the transaction. If this approach is adopted, however, the question immediately arises, what legal principles govern the distribution of power between management and shareholders when the statute is silent?

Two principles seem clear. The first is that American corporate

taxable in the bargain.

In any event, there are ways to dispose of the bathwater while retaining the baby. For example, the court can be given discretion to levy all the expenses of the proceedings against the shareholder if he has turned down an offer by the corporation and in its judgment his action in doing so was "arbitrary or vexatious or not in good faith." ABA MODEL BUS. CORP. ACT. ANN. § 74 (1960). See generally Note, *Appraisal of Corporate Dissenters' Shares: Apportioning the Proceeding's Financial Burdens*, 60 YALE L.J. 337 (1951).

statutes, as Gower says of the English Companies and Companies Clauses Acts, are

in no sense a code of company law [The statutes] do no more than consolidate the special statutory provisions applying to the particular types of company to which they relate. Behind them is the general body of law and equity applying to all companies irrespective of their nature, and it is there that most of the fundamental principles will be found.²⁶⁸

The second, a corollary of the first, is that the legal powers of shareholders are not confined to those powers explicitly conferred upon the shareholders by the statutes, certificate, or bylaws. Thus the New York court, in *Auer v. Dressel*,²⁶⁹ and the Delaware Chancellor, in *Campbell v. Loew's, Incorporated*,²⁷⁰ have both held that shareholders have the "inherent" power to remove a director for cause, notwithstanding that the power was conferred neither by statute, certificate, nor by-law (and in the *Auer* case, notwithstanding a certificate provision which vested the board with power to remove directors). Similarly, it appears to be settled that shareholders have power to appoint independent public auditors for the corporation, or to require management to issue certain types of reports, such as postmeeting reports, although the statute, certificate, and bylaws are silent on the point.²⁷¹

Beyond these two principles, however, it is unclear precisely what legal principles govern the distribution of power between shareholders and directors in the absence of statute. Some authorities, indeed, have taken the position that the board can exercise all corporate power unless the statutes explicitly provide otherwise.²⁷² This position seems unsound as a matter of policy, if the conclusions drawn in developing the normative models are correct. It also seems unsound as a matter of law.

At common law, a corporation was not required to have a board. All corporate powers were vested in the shareholders, acting by a

268. L. GOWER, *THE PRINCIPLES OF MODERN COMPANY LAW* 8 (2d ed. 1957); cf. Friedman, *SEC Regulation of Corporate Proxies*, 63 HARV. L. REV. 796, 804 (1950); Note, *Stockholder Participation in Corporate Affairs*, 37 VA. L. REV. 595, 606-07 (1951). See also I. G. HORNSTEIN, *supra* note 3, at iv (1959); R. STEVENS & H. HENN, *supra* note 183, at 26 n.50.

269. 306 N.Y. 427, 118 N.E.2d 590 (1954).

270. 36 Del. Ch. 563, 134 A.2d 852 (Ch. 1957).

271. *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); cf. Clusserath, *supra* note 191, at 45-46.

272. See *Hutchinson v. Green*, 91 Mo. 367, 1 S.W. 853 (1886); *Beveridge v. New York Elev. R.R.*, 112 N.Y. 1, 22-23, 19 N.E. 489, 494-95 (1889); cf. *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912).

majority, except insofar as they were explicitly delegated to management. Thus, Morawetz, in an early (1886) treatise in corporate law, states:

The rule was laid down by Chief Justice Bigelow as follows “. . . that every person who becomes a member of a corporation . . . agrees, by necessary implication, that he will be bound by all acts and proceedings, within the scope of the powers and authority conferred by the charter, which shall be adopted or sanctioned by a vote of the majority of the corporation This is a result of the fundamental principle, that the majority of the stockholders can regulate and control the lawful exercise of the powers conferred on a corporation by its charter.” It is implied that the majority shall have supreme authority to direct the policy of the corporation in attaining its chartered purposes, and shall have the power to appoint the usual managing agents, to whom the immediate control and direction of the company’s business is delegated.²⁷³

When a corporation had a board of directors, the common law rule was that the board had exclusive power to manage the regular business of the corporation, but the power to determine important or fundamental changes remained with the shareholders. Referring again to Morawetz:

However, the exclusive powers of the board of directors extend only to the management of the regular business of the corporation. Even an express provision that the powers of the corporation shall be exercised by its board of directors does not deprive the majority of the power of directing the general policy of the corporation, and of deciding upon the propriety of important changes in the company’s business.

. . . The general authority of the directors of a corporation extends merely to the supervision and management of the company’s ordinary or regular business. A board of directors has no implied authority to make a material and permanent alteration of the business or constitution of a corporation, even though the alteration be within the company’s chartered powers. Such an alteration can be effected only by authority of the shareholders at a general meeting.²⁷⁴

273. 1 V. MORAWETZ, TREATISE ON THE LAW OF PRIVATE CORPORATIONS 447-48 (2d ed. 1886). See also *Union Pacific Ry. v. Chicago, M. & St. P. Ry.*, 163 U.S. 564, 596 (1896); 5 W. FLETCHER, PRIVATE CORPORATIONS § 2097 (rev. vol. 1967); Warren, *Voluntary Transfers of Corporate Undertakings*, 30 HARV. L. REV. 335-36 (1917).

274. 1 V. MORAWETZ, *supra* note 273, at 479. See also A.A. BERLE & G. MEANS, *supra* note 30, at 132, and authorities cited note 3 *supra*.

The corporate statutes were enacted in the context of this common-law pattern, and generally served to perpetuate it. While some statutes confer upon the board all corporate powers except those specifically granted to shareholders,²⁷⁵ typically the statutes provide only that "the business" or "the business and affairs" of a corporation shall be managed by the board.²⁷⁶ Read in the context of the common-law background, it would appear that such statutes were not intended to derogate from the shareholders' power to make decisions on fundamental matters.²⁷⁷

Thus in *Commercial National Bank v. Weinhard*²⁷⁸ the Comptroller of the Currency had sent a notice of assessment to the Commercial National Bank pursuant to the National Banking Act, which provided that a national bank whose capital stock became impaired "shall, within three months after receiving notice thereof from the Comptroller of the Currency, pay the deficiency in the capital stock, by assessment upon the shareholders pro rata for the amount of capital stock held by each. If any such association shall fail to pay up its capital stock, and shall refuse to go into liquidation . . . a receiver may be appointed to close up the business of the association" The Act further provided that the affairs of a national bank were to be managed by its board. Following receipt of the Comptroller's notice, Commercial National Bank's board made an assessment on the shareholders, without shareholder approval, and the question was whether this assessment had been properly made. The Supreme Court held that it had not:

. . . [T]he directors are given authority to transact the usual and ordinary business of national banks. Obviously, the power conferred may be exercised in all-usual transactions . . . without consultation with the stockholders. In the present case the question to be dealt with

275. See CAL. CORP. CODE § 800 (West 1955); OHIO REV. CODE ANN. § 1701.59 (Page 1964); Act 216, § 19 [1968] Purdon's Pa. Leg. Service 442.

276. See DEL. CODE ANN. tit. 8, § 141(a) (1967); ILL. ANN. STAT. ch. 32, § 157.33 (Smith-Hurd 1954); N.J. REV. STAT. § 14A:6-1 (SUPP. 1968); N.Y. BUS. CORP. LAW § 701 (McKinney 1963); ABA MODEL BUS. CORP. ACT ANN. § 33 (1960).

277. See H. BALLANTINE, *supra* note 3, at 120; 2 W. FLETCHER, PRIVATE CORPORATIONS § 540 (rev. vol. 1954). Indeed, Fletcher asserts that this is true even under provisions which apparently confer *all* corporate powers on the board:

"Moreover, a general provision in the charter of a corporation or a general corporation law, that 'all the corporate powers shall be vested in and exercised by a board of directors, and such officers and agents as said board shall appoint,' refers merely to the ordinary business transactions of the corporation, and does not extend to other acts which are not ordinarily within the powers of the directors, but are done or authorized by the stockholders only—as the reconstruction of and fundamental changes in the corporate body, increase of the capital stock, etc." *Id.* at 598.

278. 192 U.S. 243 (1904).

is vital to the continuance of the life of the association. . . . The shareholders by their contracts of subscription have agreed to pay in the amount of capital stock subscribed and to discharge the additional liability imposed by the statute. They have not contracted to meet assessments at the will of the directors to perpetuate the business of a possibly losing concern. It would be going far beyond the usual powers conferred upon directors to permit them to thus control the corporation. Corporate powers conferred upon a board of directors usually refer to the ordinary business transactions of the corporation.²⁷⁹

Similarly, in *Hodge v. Cuba Company*²⁸⁰ the directors of Cuba Company formulated a plan under which debenture holders could take, in exchange for each existing debenture, either 1800 dollars in new debentures and \$15.37 in cash, or 1475 dollars in new debentures, \$20.87 in cash, and 150 shares of common stock. The new debentures were to be issued under an indenture whereby Cuba Company agreed that during a 12-year period it would not, over the objection of stated proportions of debenture holders, take certain actions, including the sale of stock in certain corporations, the creation of a mortgage on the assets of those corporations, or the recapitalization or reorganization of those corporations. Cuba shareholders sued to enjoin consummation of the plan on the ground, *inter alia*, that it was beyond the powers of the board. The court granted injunctive relief, stating:

While the power of directors to agree on the terms of payment of the Company's debt and to arrange for security cannot be doubted, yet when they plan so to exercise the power as to change substantially the capital structure of the Company and to control in important respects the discretion of their successors and of the stockholders for a long period, they should seek the approval of the stockholders before committing the Company.²⁸¹

Again, in *Ostlind v. Ostlind Valve Company*, the court stated flatly:

There is a distinction between the powers of the corporation itself and the powers of the board of directors, and an act may be within the powers of the former and not of the latter. . . . The powers of the

279. *Id.* at 248-49.

280. 142 N.J. Eq. 340, 60 A.2d 88 (Ch. 1948).

281. *Id.* at 348, 60 A.2d at 93.

directors are not unlimited but extend only to the ordinary or regular business of the corporation.²⁸².

In considering the traditional fundamental changes we saw that the received legal model was generally not descriptive of the statutory models of decisionmaking. However, it can now be seen that the received legal model is not entirely irrelevant as a descriptive device, for it does accurately describe the principle reflected in cases such as *Weinhard*, *Hodge*, and *Ostlind* where no statute governs, while at the same time providing that principle with secondary support. Furthermore, the model is sufficiently general that its applicability in a given case may, at least as concerns voting rights, be determined with the aid of the more highly elaborated normative models developed above. In the balance of this Article the principles embodied in the received legal model, as informed by the principles of the more highly elaborated normative models, will therefore be referred to as the common-law principles applicable to the distribution of power between shareholders and directors, and various corporate combinations and divisions will be viewed from the perspectives of both existing statutes and common-law principles. Indeed, the two perspectives are not always distinguishable, for even where a statute speaks to a question, common-law principles may be useful as an aid to statutory interpretation.

B. Corporate Combinations

In a classical merger two constituent corporations fuse pursuant to a merger agreement under which the stock of one constituent (which will hereafter be referred to as the transferor) is converted into stock of the other (which will hereafter be referred to as the survivor). The survivor then succeeds by operation of law to the transferor's assets and liabilities.²⁸³

Although at one time the classical merger probably was the dominant mode of corporate combination, in present times its scope has been so reduced that in a study of 1200 combinations during a seven-year period, only "relatively few" were found to be statutory mergers.²⁸⁴ Broadly speaking, the upstart modes of combination which

282. *Ostlind v. Ostlind Valve Co.*, 178 Ore. 161, 191, 165 P.2d 779, 791 (1946). *See also* *Railway Co. v. Allerton*, 85 U.S. 233 (1873); *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 143 N.W.2d 374 (1966); *Baker's Appeal*, 109 Pa. 461, 472 (1885); *Moore v. Los Lugos Gold Mines*, 172 Wash. 570, 588, 21 P.2d 253, 260 (1933).

283. *See* text accompanying note 188 *supra*.

284. J. BUTTERS, J. LINTNER, & W. CARY, *EFFECTS OF TAXATION - CORPORATE MERGERS* 316 & n.1 (1951). *See also* *Heilbrunn v. Sun Chem. Corp.*, 38 Del. Ch. 321, 325, 150 A.2d 755,

have shouldered aside the classical merger fall into four categories: stock-for-assets, stock-for-stock, cash-for-assets, and cash-for-stock.²⁸⁵ In order to facilitate comparison of these modes with the classical merger, in the balance of this Article a corporation which acquires assets or stock in a combination will be called the survivor, and a corporation which transfers assets, or whose stock is transferred by its shareholders, in a combination, will be called the transferor (recognizing that in the latter case this terminology is not strictly appropriate, since the transfer is made by the shareholders rather than by the corporation). We shall begin by examining the modes of combination which involve, like the classical merger, issuance of stock by the survivor.

1. *The Stock Modes*

A stock-for-assets combination may be said to occur when one corporation (the survivor) issues shares of its own stock to another corporation (the transferor) in exchange for substantially all of the transferor's assets. Typically the survivor agrees to assume the transferor's liabilities, and the transferor agrees that it will dissolve and distribute the survivor's stock to its own shareholders. Frequently it is also agreed or understood that some or all of the transferor's officers and directors will join the survivor's management.²⁸⁶ In other words, when all the shooting is over, the assets, shareholders, and often the managements of the survivor and the transferor will have been combined.

A stock-for-stock combination may be said to occur when one corporation (the survivor) issues shares of its own stock directly to the shareholders of another corporation (the transferor) in exchange for a controlling interest, normally a majority, of the transferor's stock, so that the transferor becomes a subsidiary of the survivor. The shareholder groups of the survivor and the transferor are thereby combined to a substantial extent. Frequently the transferor will then be liquidated or merged into the survivor, but whether or not this occurs the transferor's assets will be under the survivor's control for most practical purposes. Although in theory such a combination does

757 (Sup. Ct. 1959); Hills, *Consolidation of Corporations by Sale of Assets and Distribution of Shares*, 19 CALIF. L. REV. 349 (1931).

285. Cf. J. BUTTERS, J. LINTNER & W. CARY, *supra* note 284, at 316; A. WYATT, A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS 11-12 (1963).

286. See, e.g., *Rath v. Rath Packing Co.*, 257 Iowa 1277, 1280-81, 136 N.W.2d 410, 412 (1965); *Farris v. Glen Alden Corp.*, 393 Pa. 427, 430, 143 A.2d 25, 27 (1958); cf. 59 COLUM. L. REV. 366, 370 (1959).

not require approval by the transferor's management (since corporate action by the transferor is not required), in practice it is hard to accomplish such a transaction without such approval,²⁸⁷ at least in the case of a publicly held corporation. Often, therefore, the terms of the exchange of stock are worked out beforehand by the management of both corporations,²⁸⁸ and frequently it is agreed or understood that some or all of the transferor's management will stay on with the transferor in its new role as a subsidiary, or will join the survivor itself.²⁸⁹

(a) *The problem under traditional corporate statutes.*—By and large, the corporate statutes have not come directly to grips with the newer modes of combination, at least until very recently. Nevertheless, the courts have generally referred to the statutes to try to answer questions concerning the distribution of voting power over such transactions and whether they trigger appraisal rights. Not surprisingly, in view of the fact that the statutes were not expressly designed to cover such transactions, there has been a sharp split between the courts as to which statutory provisions are applicable. A priori, a stock-for-assets or stock-for-stock combination might be viewed as either a merger, on the one hand, or a purchase and sale of the transferor's assets or stock, effected through the issuance of stock by the survivor, on the other. But the rights of shareholders will often differ sharply according to which view is taken. In the case of a merger the traditional statutes normally require approval by two-thirds of the shareholders of both constituents and give all such shareholders appraisal rights.²⁹⁰ However, in the case of a sale of substantially all assets, the statutes often require approval of only a majority of the transferor's shareholders and frequently do not give such shareholders appraisal rights,²⁹¹ while in the case of a sale of stock they are completely silent concerning both voting and appraisal rights. Similarly, in the case of a purchase of assets, a purchase of stock, or an issuance of stock, the statutes are normally silent as to both voting and appraisal rights, except insofar as they confer on the

287. Cf. Fleischer & Mundheim, *Corporate Acquisitions by Tender Offer*, 115 U. PA. L. REV. 317, 348 & n.119 (1967); Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1282.

288. Cf. Orzeck v. Englehart, 41 Del. Ch. 361, 195 A.2d 375 (Sup. Ct. 1963); Applestein v. United Board & Carton Corp., 60 N.J. Super. 333, 338-40, 159 A.2d 146, 149-50 (Super. Ct. 1960), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1961).

289. See cases cited note 288 *supra*.

290. See text accompanying notes 197-99 *supra*.

291. See text accompanying notes 206-10 *supra*.

board the power to issue authorized but unissued stock²⁹² or the power to determine the consideration for which stock shall be issued.²⁹³ Important shareholder rights may therefore depend on whether a transaction is viewed as a merger. In fact, the desire to accomplish corporate combinations without giving shareholders voting or appraisal rights, or at least holding such rights to a minimum, has probably been a major impetus behind the rise of the stock modes.²⁹⁴

292. See DEL. CODE ANN. tit. 8, § 161 (1967); OHIO REV. CODE ANN. § 1701.14(A) (Page 1964); Act 216, § 34 [1968] Purdon's Pa. Leg. Service 450; *cf.* CAL. CORP. CODE § 1106 (West 1955).

293. See ILL. ANN. STAT. ch. 37, § 157.17 (Smith-Hurd 1954); N.J. REV. STAT. § 14A:7-4 (Supp. 1968); N.Y. BUS. CORP. LAW § 504 (McKinney 1963); ABA MODEL BUS. CORP. ACT. ANN. § 17 (1960).

294. *Cf.* Sealy, *The 1963 Ohio Acquisition and Merger Amendments*, 5 CORP. PRACT. COMMENTATOR 366, 367-68 (1964). It has been said that the newer modes (or at least the stock modes) were created "to avoid the impact of adverse, and to obtain the benefits of favorable, government regulations, particularly federal tax laws . . ." *Farris v. Glen Alden Corp.*, 393 Pa. 427, 432, 143 A.2d 25, 28 (1958). However, while in a given case any one non-cash mode may have distinct tax advantages, in the general run of cases the Internal Revenue Code treats the three non-cash modes substantially alike. See INT. REV. CODE OF 1954 §§ 368(a)(1)(A)(classical mergers), 368(a)(1)(B)(stock-for-stock), 368(a)(1)(C)(stock-for-assets); Kaufman & Loeb, *Corporate Reorganizations—Selected Securities, Corporate and Tax Law Considerations in Choice of Form*, 16 S. CAL. TAX INST. 199, 202-04 (1964); text accompanying notes 325-35 *infra*. If anything, the Code favors the classical merger, since this mode gives the most leeway for issuing consideration other than voting stock to the transferor's shareholders without disqualifying the combination as a tax-free reorganization. See Kaufman & Loeb, *supra*, at 204-05; Sealy, *supra*, at 367 & n.4.

Again, while in a given case one mode may be advantageous because of a non-income tax factor other than avoidance of voting and appraisal provisions, see A. CHOKA, *BUYING, SELLING, AND MERGING BUSINESSES* 1-7 (1965); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1186-1206 (1957); Kaufman & Loeb, *supra*, at 205-41, 253-54, 276-80; Stark, *Non-Income Tax Aspects of Corporate Reorganizations: A Check List of the Issues and Problems Involved*, N.Y.U. 24TH INST. ON FED. TAX. 1085 (1966), most such factors undoubtedly tend to cancel out in the general run of cases. It is often said that an important reason for using the newer modes is that the survivor wants to be free of some or all of the transferor's liabilities, particularly unknown, undisclosed, or contingent liabilities. However, in a stock-for-assets combination the survivor frequently agrees to assume the transferor's liabilities, and even if it does not it may become responsible for the transferor's liabilities under common law principles of transferee liability. see A. CHOKA, *supra*, at 105-10; Darrell, *supra*, at 1202-04. In a stock-for-stock combination followed by a merger the same result will obtain under the merger statute itself. Then too, an assets transaction will generally produce the highest incidence of state and local taxes, see Darrell, *supra*, at 1200; Kaufman & Loeb, *supra*, at 253; Stark, *supra*, at 1087-88. See generally Sato, *The Sales Tax and Capital Transactions*, 45 CALIF. L. REV. 450 (1957). Compliance with bulk sales laws may also be required, see Stark, *supra*, at 1101-02, while a stock-for-stock combination will create the greatest SEC and Blue Sky complications, see A. CHOKA, *supra*, at 15-19; Darrell, *supra*, at 1192; Stark, *supra*, at 1104-05, 1109-11, 1119-20. (But the difference in this last respect is less than it used to be. In a stock-for-stock combination in which the transferor is owned by more than a few shareholders, the survivor must deliver a prospectus to the transferor's shareholders

The cases have formulated two conflicting theories to deal with this problem. One theory, popularly known as the de facto merger theory, is usually identified with *Farris v. Glen Alden Corporation*, decided by the Pennsylvania supreme court in 1958.²⁹⁵ The gist of this theory is that if a combination has the characteristics and consequences of a merger it will be treated like a merger, even though it purports to take another form, such as a purchase of assets or stock. In *Farris* itself, Glen Alden Corporation and List Industries had agreed that List would transfer substantially all of its assets to Glen Alden in exchange for Glen Alden stock; Glen Alden would assume all of List's liabilities and change its name to List Alden; List would dissolve and distribute the stock to its shareholders; and List Alden's board would be reconstituted to include the List directors. Although in form the transaction was an acquisition of List's assets by Glen Alden, in fact Glen Alden was issuing so many shares that List's shareholders would end up with 76.5 percent of the reconstituted corporation, while Glen Alden's shareholders would end up with 23.5 percent. Furthermore, List directors would comprise a majority of the List Alden board.

Under the Pennsylvania statutes,²⁹⁶ in a merger the shareholders of both constituents had appraisal and voting rights, but in a sale of substantially all assets only the transferor's shareholders had such rights. Glen Alden nevertheless submitted the transaction to its shareholders, but not on the ground that it was a merger, and the notice of meeting did not meet the statutory requirements applicable to mergers. Glen Alden shareholders sought to enjoin the transaction on the ground that it really was a merger and that the notice of meeting was therefore defective. The lower court held for plaintiffs, on the theory that the transaction was a "*de facto* merger." The Pennsylvania supreme court affirmed, principally on the theory that the legislature had granted the appraisal right to protect shareholders against an involuntary conversion of their stock in just such a situation as was involved in *Farris*.²⁹⁷ The defendants had relied

in compliance with the 1933 Securities Act. However, if a merger or stock-for-assets combination requires approval by the shareholders of a corporation which is subject to the proxy rules promulgated by the SEC under the 1934 Securities Exchange Act, the proxy statement must contain information similar to that which must be given in a prospectus. See Stark, *supra*, at 1104-05.)

295. 393 Pa. 427, 143 A.2d 25 (1958).

296. PA. STAT. ANN. tit. 15, §§ 2852-311, 2852-902, 2852-908 (1958).

297. "Under these circumstances it may well be said that if the proposed combination is allowed to take place without right of dissent, plaintiff would have his stock in Glen Alden taken away from him and the stock of a new company thrust upon him in its place. He would

heavily on certain 1957 amendments to the corporate statutes which provided that, "[T]he right of dissenting shareholders . . . shall not apply to the purchase by a corporation of assets whether or not the consideration therefore be . . . shares . . . of such corporation."

As to these amendments, the supreme court stated:

The amendments of 1957 do not provide that a transaction between two corporations which has the *effect* of a merger but which *includes* a transfer of assets for consideration is to be exempt from the protective provisions of [the merger section . . . but] only that the shareholders of a corporation which acquires the property or purchases the assets of another corporation, *without more*, are not entitled to the right to dissent from the transaction. So, as in the present case, when as part of a transaction between two corporations, one corporation dissolves, its liabilities are assumed by the survivor, its executives and directors take over the management and control of the survivor, and, as consideration for the transfer, its stockholders acquire a majority of the shares of stock of the survivor, then the transaction is no longer *simply* a purchase of assets . . . but a merger (Emphasis added.)²⁹⁸

In *Applestein v. United Board & Carton Corporation*,²⁹⁹ a 1960 New Jersey case, the court applied the de facto merger theory to a stock-for-stock combination. United Board & Carton had entered into an agreement with Epstein, the sole owner of Interstate Container, which provided that United would acquire all of Epstein's Interstate shares in exchange for United stock; that Interstate would be "dissolved" by United, apparently through a short-form merger; that Interstate's assets and liabilities would be recorded on United's books; that Epstein would become president of United; and that United's board would be enlarged and reconstituted. As a result of the transaction Epstein would own 40 percent of United and would effectively control it.

The New Jersey merger provisions gave shareholders of both

be projected against his will into a new enterprise under terms not of his own choosing. It was to protect dissident shareholders against just such a result that . . . the legislature . . . in section 908(A), granted the right of dissent." 393 Pa. at 435, 143 A.2d at 30.

298. 393 Pa. at 437, 143 A.2d at 31; see *Marks v. Autocar Co.*, 153 F. Supp. 768 (E.D. Pa. 1957); *Marks v. Autocar Co.*, 152 F. Supp. 408 (E.D. Pa. 1955); *McCarthy v. Autocar Co.*, 152 F. Supp. 409 (E.D. Pa. 1954); *Gilbert v. Burnside*, 197 N.Y.S.2d 623, 183 N.E.2d 325 (Sup. Ct. 1959), *rev'd on other grounds*, 13 App. Div. 2d 982, 216 N.Y.S. 2d 430 (1961), *aff'd mem.*, 11 N.Y.2d 960, 229 N.Y.S.2d 10 (1962); *Block v. Baldwin Locomotive Works*, 75 Pa. D. & C. 24 (Dist. Ct. 1950). *But cf. Troupiansky v. Henry Disston & Sons*, 151 F. Supp. 609, 611-12 n.4 (E.D. Pa. 1957).

299. 60 N.J. Super, 333, 159 A.2d 146 (Ch. 1960), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1961).

constituents to a merger voting and appraisal rights.³⁰⁰ In contrast, the provision empowering a New Jersey corporation to purchase stock was silent on the subject of voting and appraisal rights, while the short-form merger provision specifically denied such rights to the survivor's shareholders. United nevertheless submitted the transaction to its shareholders, but only because of certain requirements of the New York Stock Exchange.³⁰¹ United shareholders brought suit, arguing that the transaction was a merger and that the notice of meeting did not meet the statutory requirements applicable to mergers. The court granted relief, on the theory that the purchase-of-assets and short-form merger provisions could not be used to accomplish a *de facto* merger and thereby subvert the general merger provisions:

. . . [W]hen an authorized device, such as that provided for in a sale or purchase of assets, or a dissolution, is used to bring about a virtual consolidation or merger, minority shareholders may object on the ground that a direct method has been authorized for such a purpose. . . . It would be strange if the powers conferred by our Legislature upon corporations . . . for a purchase of the property and shares of another corporation and . . . for the merger of a parent corporation with a wholly-owned corporation can effect a corporate merger *de facto*, with all the characteristics and consequences of the merger, without any of the legislative safeguards and rights afforded to a dissenting shareholder in a *de jure* merger If that were so, we obtain the anomalous result of one part of the corporation law rendering nugatory another part of the same law in accomplishing the same result.³⁰²

Squarely in conflict with the *de facto* merger theory reflected in these cases is the equal-dignity theory applied by the Delaware court in a pair of 1963 decisions. The first of these, *Hariton v. Arco Electronics*,³⁰³ like *Farris*, involved a stock-for-assets combination. Arco Electronics and Loral Electronics had agreed that Arco would transfer all of its assets to Loral in exchange for Loral stock; that Loral would assume Arco's liabilities; and that after receiving the Loral stock Arco would dissolve and distribute the stock to its shareholders. The Delaware statute gave appraisal rights to the

300. 60 N.J. Super. at 343, 159 A.2d at 151-52.

301. See text accompanying note 399 *infra*.

302. 60 N.J. Super. at 344-45, 159 A.2d at 152-53.

303. 41 Del. Ch. 74, 188 A.2d 123 (Supp. Ct. 1963), *aff'g* 40 Del. Ch. 326, 182 A.2d 22 (Ch. 1962).

shareholders of both constituents to a merger, but to the shareholders of neither party to a sale of substantially all assets. An Arco shareholder sued to enjoin consummation of the transaction on the ground that it was a merger and he had unlawfully been denied his appraisal rights. The court denied the injunction. Whereas *Farris* and *Applestein* had focused on the fact that the combinations at issue had the effect of a merger, and therefore had to meet the requirements of the merger provisions lest "we obtain the anomalous effect of one part of the corporation law rendering nugatory another part of the same law in accomplishing the same result," the Delaware court in *Hariton* argued that all corporate statutory provisions were of equal dignity, and that if a transaction was accomplished by one provision it could not be tested by the demands of another:

Plaintiff's contention that this sale has achieved the same result as a merger is correct. . . . [T]his result is made possible by the overlapping scope of the merger provision [and the sale-of-substantially-all-assets provision]. . . . The reorganization here . . . is legal. This is so because the sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization may resort to either type of corporate mechanics to achieve the desired end.³⁰⁴

*Orzeck v. Englehart*³⁰⁵ involved, like *Applestein*, a stock-for-stock combination. Bellanca Corporation agreed with C.D. and H.G. Olson that the Olsons would transfer to Bellanca all their stock in seven corporations in exchange for Bellanca stock, stock options, cash, and property. The transaction gave the Olsons control of Bellanca, and after the transfer Bellanca changed its name to Olson Brothers, Inc. and merged its seven new subsidiaries into itself through short-form mergers. A Bellanca shareholder challenged the transaction on the ground that it constituted a de facto merger and that the merger provisions had not been complied with. The court rejected this challenge, vigorously reiterating and elaborating the equal-dignity theory developed in *Hariton*:

While the argument made may have a surface plausibility, it nevertheless is contrary to the uniform interpretation given the Delaware Corporation Law over the years to the effect that action taken in accordance with different sections of that law are acts of

304. 41 Del. Ch. at 76, 188 A.2d at 125.

305. 41 Del. Ch. 361, 195 A.2d 375 (Sup. Ct. 1963).

independent legal significance even though the end result may be the same under different sections. . . .

The effect of the [Delaware] cases is to make it plain that the general theory of the Delaware Corporation Law is that action taken under one section of that law is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means.³⁰⁶

This theory was squarely rejected two years later by the Iowa Supreme Court in *Rath v. Rath Packing Company*.³⁰⁷ That case concerned a stock-for-assets transaction along the lines of *Farris*, with Rath Packing nominally acquiring the assets of Needham Packing in exchange for its own stock. The combination was submitted to Rath's shareholders, but not on the ground that it was a merger. At the meeting it was approved by shareholders holding 77 percent of the shares actually voted, but only 60.1 percent of total outstanding stock. Rath shareholders brought suit to enjoin consummation of the transaction on the theory that it was really a merger, and accordingly required two-thirds approval under the statute. Defendants relied principally on the equal-dignity theory, arguing that shareholder approval was not required because the transaction fell within the provisions governing the amendment of certificates and the issuance of stock; the former required only majority shareholder approval, and the latter did not refer to shareholder approval at all. The court concluded that the transaction was a merger "under any definition of merger we know," and rejected the equal-dignity theory on two grounds: under the rule of statutory construction that the specific controls the general, and that mergers were therefore governed by the (specific) merger provisions even if the transaction also fell within (more general) provisions, such as those involving issuance of stock or amendment of certificates; and under the *Applestein* principle that "'one part of the corporation law [should not be permitted to render nugatory] another part of the same law in accomplishing the same result.'" ³⁰⁸

306. *Id.* at 365-67, 195 A.2d at 377-78; see *Eidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Ch. 1952); *cf.* *Stauffer v. Standard Brands Inc.*, 40 Del. Ch. 202, 178 A.2d 311 (Ch. 1952), *aff'd.* 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962); Comment, *Jurisdiction of the California Corporations Commissioner over Delaware Short Form Mergers*, 52 CALIF. L. REV. 1016 (1964).

307. 257 Iowa 1277, 136 N.W.2d 410 (1965). *But see* *Pomierski v. W.R. Grace & Co.*, 282 F. Supp. 385 (N.D. Ill. 1967) (purporting to apply Iowa law).

308. 257 Ia. at 1289, 136 N.W.2d at 417.

(b) *The meaning of "merger."*—Although the Delaware position is a minority view, it has generally received the commentators' approbation.³⁰⁹ Thus the result in *Farris* has been described as "a blaze of Platonism," because it is based upon finding "a 'true and real merger' that exists beyond, and is merely reflected in, the merger statutes,"³¹⁰ whereas the Delaware cases are praised for "requiring only adherence to form," thereby affording an objective test and avoiding "the inherent complexities of a judicial test which seeks a 'real' merger beyond the form of the transaction."³¹¹ Is this analysis just?

Preliminarily it should be noted that while the Delaware courts have tended to treat stock combinations as if they all raised the same issue—is the transaction in question a "de facto" merger?—in fact each case tends to raise somewhat different issues, because there are three major variables in such cases: The nature of the combination (stock-for-assets or stock-for-stock); the class into which the complainants fall (shareholders of the transferor in a stock-for-assets combination, shareholders of the survivor in a stock-for-assets combination, or shareholders of the transferor in a stock-for-stock combination);³¹² and the nature of the right alleged to have been denied (appraisal rights or voting rights—and in the case of voting rights, the right to vote at all or the right to insist on two-thirds approval).

Thus in *Heilbrunn v. Sun Chemical Corporation*,³¹³ (a Delaware case preceding *Hariton v. Arco Electronics*), suit was brought by the shareholders of a survivor in a stock-for-assets combination. The transaction had been submitted to and approved by the survivor's shareholders, but had not received the two-thirds vote required to approve a merger. Both the appraisal and the voting right were therefore in question, but the appraisal question was whether the shareholders had appraisal rights at all, while the voting question was whether majority approval sufficed. In statutory terms, the issue was

309. See, e.g., Folk, *De Facto Mergers in Delaware*, *supra* note 235; Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 257; cf. Note, 47 CALIF. L. REV. 180 (1959); Note, 59 COLUM. L. REV. 366 (1959); Note, 51 IOWA L. REV. 1096 (1966). *But cf.* 107 U. PA. L. REV. 420 (1959).

310. Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 257. See also Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1277.

311. Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1277.

312. The shareholders of the transferor in a stock-for-stock transaction typically are not complainants. For the probable reasons, see text accompanying note 401 *infra*.

313. 38 Del. Ch. 321, 150 A.2d 755 (Sup. Ct. 1959). This case involved a fact pattern and statutory provisions similar to those involved in *Rath*. However, for some reason the court focused on the sale-of-substantially-all-assets provisions, rather than the issue-of-stock provision.

whether the transaction was a merger, in which case the statute gave the survivor's shareholders appraisal rights and required two-thirds shareholder approval, or a purchase of assets, in which case the statute was silent on voting and appraisal rights.

In *Hariton v. Arco Electronics*, suit was brought by the shareholders of the transferor in a stock-for-assets combination. The transaction was submitted to the transferor's shareholders, and approved by more than the two-thirds required for a merger, so that only the appraisal right was in question. In statutory terms, the issue was whether the transaction was a merger, in which case the statute gave the transferor's shareholders appraisal rights, or a sale, in which case it did not.

In *Orzeck v. Englehart*, suit was brought by shareholders of the survivor in a stock-for-stock combination. The transaction had not been submitted to shareholders at all, so that both voting and appraisal rights were in question, and in both instances the question was whether the complainants had such rights at all. In statutory terms, the issue was whether the transaction was a merger, in which case the statute gave survivor's shareholders appraisal and voting rights, or a purchase of stock, in which case the statute was silent.

Despite the differences between these cases, one issue was nevertheless common to all: Was the combination in question a "merger" or a "sale/purchase"? To deal with these cases the Delaware court applied its equal-dignity theory—that the validity of "action taken under one section of [the Delaware corporation] law . . . is not dependent upon, nor to be tested by the requirements of other unrelated sections." As applied to combination cases, this theory apparently means that the validity of action taken under sale (or purchase) provisions is not to be tested by the requirements of merger provisions. But this theory is virtually irrelevant to the primary issue, namely whether the combination in question is a merger or a sale. It is in no way responsive to that issue to say, as the equal-dignity theory says, that *if* a combination is a *sale*, it need not meet the requirements of the merger provisions. The Delaware courts have dealt with the primary issue before them simply by assuming it away.

There is an approach to which the equal-dignity theory is relevant—an approach based on the theory that if a transaction achieves a result within the ambit of one statutory provision it must comply with that provision even though it is purportedly achieved

under another, lest the purpose of the first provision be subverted.³¹⁴ It is this approach—suggested in *Farris*, emphasized in *Applestein*, and reiterated in *Rath*—which is evoked by the phrase “de facto merger,” connoting as it does a transaction which is a merger in fact but not strictly speaking. But, like the equal-dignity theory, the de facto merger approach is relevant only on the assumption that the combination in question is strictly speaking a sale, because if the combination is strictly speaking a merger, the court need not go through de facto gyrations—it can merely point out that a merger must comply with the merger provisions. Thus, neither the equal-dignity theory nor the de facto theory is called for until the court has resolved the crucial issue whether the combination in question is a merger or a sale within the meaning of the statute.

In short, then, a court which applies the equal-dignity theory must implicitly assume that the transaction before it is a sale, and not a merger. But on what basis (if any) is that assumption made? The Delaware courts which authored the theory do not tell us, nor do the approving commentators.³¹⁵ In both *Heilbrunn*³¹⁶ and *Hariton*³¹⁷ the Delaware supreme court stated that the merger and sale provisions are “overlapping.” Clearly the facts of the cases show this to be true. But what are the implications of this overlap? If the provisions are overlapping, is a stock-for-assets transaction a merger or a sale within the statute? Or is it both?

The commentators have criticized cases like *Farris* for having platonically found “a ‘true and real merger’ that exists beyond, and is merely reflected in, the merger statutes.” The crucial premise of this criticism is that the meaning of the term “merger” is defined by the statutes—if it is not, then the courts *must* look “beyond . . . the merger statutes” to determine what “merger” means, and whether a given combination is a merger. To deal with this premise let us then turn to the statutes to see how they define a merger.

The New York business corporation law is typical in this regard. Section 901(a)(1) provides that, “Two or more domestic corporations may . . . merge into a single corporation which shall be one of the constituent corporations.” Section 902 provides that “the board of each corporation proposing to participate in a merger . . . shall

314. Cf. Lattin, *Minority and Dissenting Shareholders' Rights in Fundamental Changes*, 23 LAW & CONTEMP. PROB. 307, 313 (1958): “One authorized device may not be used to accomplish a result within the purview of another authorized device” See text accompanying notes 448-49 *infra*.

315. See the secondary literature cited in note 309 *supra*.

316. 38 Del. Ch. at 325, 150 A.2d at 757 (Sup. Ct. 1959).

317. 41 Del. Ch. at 76, 188 A.2d at 125 (Sup. Ct. 1963).

approve a plan of merger" setting forth the names of the constituents and the survivor, "the terms and conditions of the proposed merger . . . including the manner and basis of converting the shares of each constituent corporation into . . . securities of the surviving . . . corporation," any amendments to the survivor's certificate to be effected by the merger, and so forth. Section 903 provides that "the board of each constituent corporation, upon approving such plan of merger . . . shall submit such plan to a vote of shareholders." Section 904 provides that after the plan of merger has been approved, a certificate setting forth its major terms shall be delivered to the department of state. Section 906 provides that upon the filing of the certificate the surviving corporation shall succeed to the assets and liabilities of each constituent.

In short, the statute (and to repeat, the New York statute is completely typical) nowhere defines a merger. It lays down the procedures necessary to effectuate a merger; it lays down the legal consequences of a merger; but it nowhere defines a merger. We know that if a merger is effected, two corporations become one. We know nothing more—at least from the statute. Why not? Probably because the legislature thought that a merger was a well-understood business transaction, no more in need of definition than a mare. In other words, a merger is precisely something that "exists beyond, and is merely reflected in, the merger statutes." A merger is a real-live-flesh-and-blood thing that businessmen do and legislators regulate. The platonist is one who thinks that mergers are created by Caesar rather than Crassus.

But then what is the business transaction which the legislature contemplated? In common usage, as evidenced by Webster, "merge" means "to cause to be swallowed up . . . to cause to combine, unite, or coalesce," while "merger" means "with reference to corporations . . . the vesting of the control of different corporations in a single one by the issue of stock of the controlling corporation in place of a majority of the stock of the others" ³¹⁸ Similarly, *Black's Law Dictionary* defines a corporate merger as "the union of two or more corporations by the transfer of property of all to one of them, which continues in

318. WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1539 (2d ed. 1960). Webster's third edition gives the same definition of "merge," and a simpler but substantially identical definition of "merger;" i.e., "absorption by a corporation of one or more others . . . [or] any of various other methods of combining two or more business concerns." WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1414 (3d ed. 1967). The remaining definitions of the term in both editions pertain to other situations (e.g. a merger of proprietary estates), and are not inconsistent with those set forth in the text.

existence, the others being swallowed up or merged therein."³¹⁹ Economic and financial usage tends to subsume under the term "merger" any business combination involving the issuance of stock.³²⁰ The statutory scheme, although it does not define mergers, shows that the legislature contemplated a transaction in which two corporations are fused through the issuance of stock by one.

All this points in one direction: The business transaction contemplated by the legislature when it used the term "merger" is a combination of two corporations through the issuance of stock by one, resulting in a fusion, and therefore includes a stock combination resulting in such a fusion. In fact, once it is understood that the statutes do not define a merger, it is difficult to see how the term can be construed so as not to include such combinations—unless it is construed to mean only combinations which the board labels a merger.³²¹ But such a construction seems impermissible. First, it would render almost meaningless the legislative prescription that a merger requires shareholder approval and gives rise to appraisal rights. This prescription is intended to protect shareholders: Unless it clearly so indicates, the legislature cannot be presumed to have intended that management could nullify these rights through the mere expedient of labeling. Correspondingly, under most statutes at least, there is no warrant for such an approach simply because there is nothing to indicate that the consequences of a combination are somehow governed by an election made by management which is evidenced by a label. Indeed, the Delaware courts themselves have recognized that labels are of no consequence in determining whether a transaction is a merger or a sale. Thus in *Fidanque v. American Maraicaibo Company* (which held that a stock-for-stock combination was not a merger) the Vice Chancellor stated that "there is no magic in the words applied to the transaction. Calling it a merger does not necessarily make it so and giving it another name does not prevent it from being a merger."³²² Similarly, in *Heilbrunn*, (which held that a stock-for-assets transaction was not a merger) the transaction was apparently labeled a "reorganization," but the supreme court rightly

319. BLACK'S LAW DICTIONARY 1140 (4th ed. 1951); see, e.g., *Rath v. Rath Packing Co.*, 257 Iowa 1277, 1285-86, 136 N.W. 2d 410, 415 (1965); Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L. REV. 254 (1957).

320. See, e.g., "American General Agrees to Acquire Stock of Insurer," *Wall Street Journal*, July 10, 1968, at 4, col. 2 (which begins a description of a stock-for-stock combination by stating that "American General Insurance Co. and Southwestern Life Insurance Co. said they have agreed to merge.").

321. *Cf.* 107 U. PA. L. REV. 420, 424 (1959).

322. 33 Del. Ch. 262, 269, 92 A.2d 311, 316 (Ch. 1952).

brushed this aside on the ground that, "The contract was in legal effect one of purchase and sale."³²³

In short, the term "merger" as used in most corporate statutes seems to include at least some stock combinations.³²⁴ It therefore seems unnecessary and even inappropriate to view such transactions as "de facto mergers"; they should more appropriately be referred to as de jure mergers, or, if it is thought necessary to distinguish them from the classical merger—one in which that label is used—as stock-for-assets or stock-for-stock mergers.

This brings us, however, to a much more difficult set of questions: (1) Assuming that the stock modes of combination may be deemed mergers within the statutes, may they also be deemed sales? (2) If so, which statutory provisions govern—those relating to mergers or those relating to sales? To put this second question differently, if a class of transactions can be deemed either mergers or sales within the meaning of the statute, is there a way to differentiate between those members of the class which should be treated as mergers and those which should be treated as sales?

The corporate cases provide little help on this crucial problem. However, two allied disciplines—tax and accounting—have wrestled with problems involving differentiations between sales and combinations for a number of years. We shall therefore briefly review the solutions in these areas to see what light they shed on the corporate law problem.

(c) Tax treatment of the combination problem.—Under the Internal Revenue Code, a sale of stock (other than by the issuing corporation) or of assets has traditionally constituted a taxable event, but a transfer of stock or assets in connection with certain types of corporate combinations has been wholly or partially nontaxable since the 1918 Act, which made special provision for the exchange of stock or securities "in connection with the reorganization, merger, or consolidation of a corporation."³²⁵ Although the term "reorganization" was left undefined by that Act, succeeding statutes

323. 38 Del. Ch. at 328, 150 A.2d at 759 (Sup. Ct. 1959). In *Hariton, Rath, and Farris* the transaction was also labeled a "reorganization," not a "sale."

324. Cf. Rule 16b-7(b) under the Securities Exchange Act of 1934: "A merger within the meaning of this rule shall include the sale or purchase of substantially all the assets of one company by another in exchange for stock which is then distributed to the security holders of the company which sold its assets;" the definition of "reorganization" in the 1921, '24, '26, '28, and '32 Revenue Acts, as quoted in R. PAUL, *STUDIES IN FEDERAL TAXATION*, Exhibit A (facing 164) (3d Series 1940). The 1921 Act, for example, read: "[R]eorganization means . . . (A) a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation)" (Emphasis added in both quotations.)

325. See R. PAUL, *supra* note 324, at 19; Hellerstein, *supra* note 319, at 258.

elaborated both its definition and its consequences.³²⁶ Thus the 1921 Act defined "reorganization" to include "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and . . . of all other classes of stock of another corporation, or of substantially all the properties of another corporation)." ³²⁷ Read literally, this definition was applicable regardless of the consideration given by the survivor. However, the rationale for the special tax treatment accorded to reorganizations has been that, "[T]he new enterprise, the new corporate structure, and the new property are substantially continuations of the old [investment] still unliquidated," ³²⁸ or to put it differently, that, "[T]he taxpayer's investment remains in 'corporate solution.'" ³²⁹ Therefore, it was soon held that the reorganization provisions presupposed that the transferor's shareholders enjoyed a "continuity of interest" in the reconstituted corporation—presupposed, in other words, that as a result of the transaction the transferor's shareholders would have converted a substantial portion of their stock in the transferor into stock in the survivor. If this requisite continuity of interest did not exist, then the courts held that despite literal compliance with the statutory definition the transaction was not a "reorganization" within the meaning of the Code, but a "sale" ³³⁰ and therefore a taxable event.

Section 368(a)(1) of the present (1954) Code includes within the definition of "reorganization:" ³³¹ (A) "a statutory merger or consolidation"; (B) "the acquisition by one corporation, in exchange solely for . . . its voting stock . . . of stock of another corporation,"

326. Under the 1954 Code, exchanges in connection with a reorganization (as defined) are tax free to both the corporations and their shareholders if the sole consideration given by the survivor is shares of its own stock. See INT. REV. CODE OF 1954 §§ 1032(a) (survivor), 361(a)(transferor), 354(a)(1) (shareholders). Within limits, mergers and stock-for-assets combinations can qualify as reorganizations even if consideration other than stock is issued, but gain will be recognized to the extent of such consideration.

327. See R. PAUL, *supra* note 324, at Exhibit A.

328. Treas. Reg. § 1.1002-1(c) (1968).

329. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 500 (2d ed. 1966).

330. See *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); B. BITTKER & J. EUSTICE, *supra* note 329, at 508-10; Hellerstein, *supra* note 319, at 260-61.

331. These definitions derive from the 1934 Act. See R. PAUL, *supra* note 324, at 36-40 & Appendix A. The term "reorganization" as used in the Code also includes a "recapitalization," INT. REV. CODE OF 1954, § 368(a)(1)(E), a "mere change in identity, form, or place of organization," § 368(a)(1)(F), and certain corporate divisions, see §§ 368(a)(1)(D), 355, and text accompanying notes 538-43 *infra*. The present section of this article is confined to reorganizations taking the form of a combination, with which the term is most typically identified.

provided that after the acquisition the survivor owns at least 80 percent of the total voting power and total number of shares of the transferor; and (C) "the acquisition by one corporation . . . of substantially all of the properties of another corporation" if at least 80 percent of such property is acquired in exchange for voting stock of the survivor.³³² The effect of provisions (B) and (C) is to build into the statute the continuity-of-interest concept developed by the courts, in stock-for-assets and stock-for-stock combinations,³³³ because under these provisions such transactions will constitute reorganizations only if 80 percent or more of the transferor's stock is transmuted into voting stock of the survivor. And while Section 368(a)(1)(A) does not codify a continuity-of-interest test for statutory mergers, the test remains applicable to such transactions,³³⁴ the Internal Revenue Service having ruled that it will be satisfied if at least 50 percent of the stock in the transferor is transmuted into stock in the survivor.³³⁵

Thus the tax law has developed as its principal test for distinguishing between reorganizations and sales the presence vel non of a substantial continuity of interest by the transferor's shareholders in the reconstituted enterprise. However, many commentators have felt that to distinguish adequately between reorganizations and sales the Code should add a second requirement—that the interest received by the transferor's shareholders represents a substantial proportionate stake in the reconstituted enterprise:

The statutory definition of reorganization hauls in a most variegated catch but does nothing to segregate the transactions according to their economic consequences. Thus . . . the merger of an independent corner grocery store into a national food chain [is a "reorganization"] although the local merchant who has exchanged his

332. In determining whether 80 percent of the transferor's property is acquired for voting stock of the survivor, the amount of any liability which is assumed by the survivor, or to which the acquired property is subject, is treated as money paid for such assets—that is, as consideration other than voting stock. Since most stock-for-assets transactions involve either an assumption of liabilities by the survivor or the acquisition by it of property subject to liabilities, for practical purposes in many C reorganizations the survivor will not be able to issue consideration other than voting stock, notwithstanding its theoretical power to do so.

333. Cf. B. BITTKER & J. EUSTICE, *supra* note 329, at 514-15.

334. Treas. Reg. § 1.368-1(b) (1955).

335. Rev. Rul. 66-224, 1966-2 CUM. BULL. 114; Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, 1233. The 50 percent test will be satisfied if shareholders holding half the transferor's stock receive only stock in the survivor, or if at least half the total consideration received by all of the transferor's shareholders is stock in the survivor. *Id.* It has been suggested that in the context of an audit a 40 percent continuity of interest would be deemed sufficient by the IRS National Office, MacLean, *Creeping Acquisitions*, 21 TAX. L. REV. 345, 355-56 (1966).

stock for the marketable stock of the surviving corporation may feel, quite rightly, that he has "sold out."³³⁶

This principle was reflected in the approach of the Draft Federal Income Tax statute published by the American Law Institute in February 1954, which provided that, generally speaking, a combination would not qualify as a reorganization unless the transferor's shareholders received 20 percent of the survivor's stock (by voting power or by value).³³⁷ This approach was substantially adopted by the House version of the 1954 Code,³³⁸ but was rejected by the Senate,³³⁹ and did not appear in the final version of section 368. However, the philosophy of this approach was reflected in section 381(b), added by the Senate, which limits the tax benefits enjoyed by the survivor when the transferor's shareholders get less than a 20 percent stake in the survivor.³⁴⁰

(d) Accounting treatment of the combination problem.—The accounting treatment of business combinations has developed in a manner strikingly similar to the tax treatment. At first, most arm's-

336. B. BITKER & J. EUSTICE, *supra* note 329, at 499-500.

337. 2 ALI FED. INCOME TAX STAT. §§ X500(f), X601(a), X602(a) (Feb. 1954 Draft), and Comments to X601 at 309-10, and to X602 at 312-13.

338. H.R. 8300, 83d Cong., 2d Sess. §§ 354, 359 (1954). The ALI Draft would have permitted a less-than-20 percent stake to be issued to a transferor's shareholders where: (1) The combination involved two or more transferors, (2) the shareholders of each such transferor obtained at least a five percent stake in survivor, and (3) the combined stock interest issued to the shareholders of all the transferors equalled at least a 20 percent stake in the survivor. The House Bill generally followed these provisions as to stock-for-stock and stock-for-assets combinations, and as to mergers involving at least one closely held corporation, but eliminated the relative-size test in the case of statutory mergers involving two publicly held corporations (defined as corporations in which ten or fewer persons did not own more than 50 percent of the stock by voting power or value). See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 39-40 (1954).

In 1958 a group consisting of the ALI Tax Project's staff and a committee of the ABA's Section of Taxation proposed a revision of Section 368 in which the desirability of a relative-size test, and the precise figure to be employed if such a test were adopted, were both left open. The asserted reason for this was that the "relative size aspect of the continuity of interest problem raises questions of policy which are more far-reaching than the other aspects of the problem." ALI FEDERAL INCOME, ESTATE, AND GIFT TAX PROJECT, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 266-73, 326-28 (1958). At best, the group had a breathtaking ability to distinguish between the policy significance of its various decisions. At worst, the mating of the ALI with the ABA resulted, not surprisingly, in loss of the ALI's virginity.

Similarly, the Advisory Group on Subchapter C of the Internal Revenue Code of 1954 (appointed by the Internal Revenue Taxation Subcommittee of the House Ways and Means Committee) considered, but did not recommend, adoption of a relative size test, "although further consideration might be given to it as a policy matter." *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code before the House Ways and Means Committee*, 86th Cong., 1st Sess. 555 (1959).

339. See S. REP. NO. 1622, 83d Cong., 2d Sess. 51 (1954).

340. See S. REP. NO. 1622, 83d Cong., 2d Sess. 53 (1954).

length combinations were accounted for as purchases by the survivor, particularly if the constituents were of disparate size. Thus in a classical merger or a stock-for-assets combination the survivor wrote up the transferor's assets to their actual value, and the transferor's capital and surplus accounts—in particular, its earned surplus—were wiped out. However, just as in tax cases the courts had come to distinguish between purchases and reorganizations, so the accountants began to differentiate between purchases and “poolings of interest,” the latter being defined very much like reorganizations, and given very similar treatment.³⁴¹

The definition and consequences of a pooling of interest have been undergoing development for a number of years. *Accounting Research Bulletin No. 48*, issued by the American Institute of Certified Public Accountants in 1957,³⁴² explicitly rejects any distinction between business combinations based on “legal form (such as a merger, an exchange of shares . . . or an issuance of stock for assets and businesses).” Instead, it sets out various substantive criteria by which purchases can be distinguished from poolings, the most important of which is the presence of a continuity of interest (although that term is not expressly used in *A.R.B. 48*, just as it is not expressly used in the Code). A “purchase” is defined as a combination “in which an important part of the ownership interests in the acquired corporation . . . is eliminated or in which other factors requisite to a pooling of interests are not present.” A “pooling” is defined as a combination “in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors . . . are present.”

The “other factors” mentioned in both definitions include continuity of business, continuity of management, and relative size.

341. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 48 (1957) [hereinafter cited as A.R.B. 48]; A. WYATT, A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS (A.I.C.P.A. ACCOUNTING RESEARCH STUDY No. 5) 13-15, 19-25 (1963) [hereinafter cited as WYATT].

342. Opinion 10 of the Accounting Principles Board, issued in 1966, amended A.R.B. 48 in certain respects not here material. See A.I.C.P.A., OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD 144-45 (1966). For treatments of the problem prior to A.R.B. 48, see A.R.B. 40 (1950); A.R.B. 43, Chapter 7(c) (1957). See generally Barr, *Accounting Aspects of Business Combinations*, 34 ACCTG. REV. 175 (1959); Black, *Certain Phases of Merger Accounting*, 83 J. ACCTCY. 214 (1947); Werntz, *Intangibles in Business Combinations*, 103 J. ACCTCY. 46 (1957); Wilcox, *Business Combinations: An Analysis of Mergers, Purchases, and Related Accounting Procedure*, 89 J. ACCTCY. 102 (1950).

However, since continuity of business will almost invariably be present in a combination, and since continuity of management will normally be present, the most important of these "other factors" is obviously relative size. As to this factor, *A.R.B. 48* states that:

Relative size of the constituents may not necessarily be determinative, especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.³⁴³

If a combination is deemed to be a pooling rather than a purchase, the accounting treatment strongly resembles the tax treatment given to reorganizations. Thus, just as in a reorganization the survivor takes over the transferor's assets at the basis they had in the hands of the transferor, so in a pooling the survivor takes over the transferor's assets at the book value they had in the hands of the transferor; and just as in a reorganization the survivor succeeds to the transferor's earnings and profits, so in a pooling the survivor succeeds to the transferor's earned surplus.³⁴⁴ This similarity in treatment stems from the fact that the theory justifying the pooling concept is substantially equivalent to the theory justifying the reorganization concept:

[N]o new basis of accountability is required since the two (or more) new companies are continuing operations as one company in a manner similar to that which existed in the past. The presumption is that in effect there has been no purchase or sale of assets, but merely a fusion, merging, or pooling of two formerly separate economic entities into one new economic entity.³⁴⁵

An additional word should be said here about the relative-size test. We have already seen that the significance of this test has posed a difficult problem to tax theoreticians. It has posed little less of a problem to accountants. Although *A.R.B. 48* expressly makes relative size a factor in determining the applicability of pooling accounting, an Accounting Research Study published in 1963 showed a strong tendency on the part of accountants to disregard this factor. Many

343. *A.R.B. 48*, *supra* note 341, at para. 6.

344. *Id.* at para. 9.

345. WYATT, *supra* note 341, at 15.

combinations were accounted for as poolings even though the smaller corporation was less than three percent of the size of the larger; in one case, the relative sizes were 99.7 percent and 0.3 percent.³⁴⁶ The reason for this was said to be that the relative size test “appeared illogical.” A question frequently posed was: “What is it that permits a 5.1 percent combination to be considered a pooling of interests and prevents a 4.9 percent combination from being so considered?”³⁴⁷ This question—which may be motivated by self-interest, since in general the accountants’ clients prefer pooling accounting to purchase accounting because it keeps down depreciation charges, thereby increasing annual income³⁴⁸—squarely misses the point. Any defense of pooling must rest on the theory that, “In a purchase one company does acquire control over the assets of another, but that does not hold true in a pooling of interests. . . . [R]ather the shareholders who controlled one company join with the shareholders who controlled the other company to form the combined group of shareholders who control the combined companies.”³⁴⁹ But there is clearly some point at which the survivor is so much larger than the transferor that to say the “combined group of shareholders [now] control the combined companies” is at best a good joke on readers of financial statements. Whether such readers begin to laugh at 5.1 percent or 4.9 percent depends on the delicacy of their sense of humor; but to throw out a relative-size test completely—particularly so modest a test as that laid down by *A.R.B. 48*—would seem to undercut in large measure the theoretical foundation of pooling accounting. Nevertheless, unless and until the present trend is reformed, it appears that the de facto test for the applicability of pooling accounting, like the de jure test for the applicability of the reorganization provisions, will be the presence of a continuity of interest by the transferor’s shareholders, regardless of the proportionate significance of this interest in the reconstituted enterprise.³⁵⁰

346. *Id.* at 27-28, 50-52.

347. *Id.* at 28.

348. See G. CATLETT & N. OLSEN, ACCOUNTING FOR GOODWILL 49-50 (Accounting Research Study No. 10, 1968); WYATT, *supra* note 341, at 58; Briloff, *Dirty Pooling*, 42 ACCTG. REV. 489 (1967).

349. Holsen, *Another Look at Business Combinations*, in WYATT, *supra* note 341, at 110.

350. The A.I.C.P.A.’s Accounting Principles Board intends to reconsider the entire matter of business combinations. A.I.C.P.A., OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD 144 n.6 (1966). Two recent accounting research studies prepared for the Accounting Principles Board have recommended that most combinations be accounted for as purchases. See G. CATLETT & N. OLSEN, *supra* note 348, at 66; WYATT, *supra* note 341, at 109. However, it seems doubtful that this view will prevail. See Comments by the Project Advisory Committee and the Director of Accounting Research in G. CATLETT & N. OLSEN, *supra* note 348, at 116-66.

(e) *Lines of solution.*—The tax and accounting treatment of combinations suggests several lines of solution to the combination problem under corporate law. Since the solutions depend upon the nature of the transaction and the identity of the complainant, we will break the problem down into four parts, according to whether the transaction is stock-for-assets or stock-for-stock and whether the complainants are shareholders of the transferor or the survivor.

(i) *Shareholders of the transferor in stock-for-assets combinations*

(A) *The meaning of "sale"—a continuity-of-interest test.*—We have seen that a stock-for-assets transaction may be deemed a merger within the meaning of the corporate statutes. Is it also a sale? A strong argument can be made that it is not, at least for purposes of the sale-of-substantially-all-assets provisions.

Suppose *A* and *B* organize a partnership, *AB*, and each contributes to the partnership a going business. Generally speaking, neither lawyers nor laymen would say that *A* has "sold" his business (or that *AB* has "purchased" it). The reason *A*'s transfer would not normally be called a "sale" is that the term "sale" most commonly refers to a transaction in which a transferor disposes of his interest in the thing transferred, whereas in the hypothetical, *A* retains an interest—a continuity of interest—in the transferred business. Now suppose that *AB* is not a partnership, but a corporation? Again, generally speaking neither lawyers nor laymen would call *A*'s transfer of his business to *AB* a "sale" by *A* (or a "purchase" by *AB*), and for the same reason. But then suppose *A* makes the transfer to *AB* when *AB* is an existing corporation, wholly owned by *B*? Still the transaction would not normally be described as a "sale" by *A* (or a "purchase" by *AB*). But this last case is a stock-for-assets transaction.

Therefore, one possible solution to the problem presented by the stock-for-assets combination from the transferor's perspective is that such a transaction is not a sale at all, because by hypothesis (that is, we have defined such a combination to be a transfer of substantially all of the transferor's assets in exchange for the survivor's stock) the transferor and its shareholders retain a continuity of interest in the transferred assets. Thus in *Paterson v. Shattuck Arizona Copper Company*,³⁵¹ Shattuck Arizona and Denn Arizona agreed to transfer their assets to Shattuck Denn, a new corporation which they had caused to be organized, in exchange for Shattuck Denn stock. The issue was whether this transaction constituted a sale by Shattuck Arizona. The court said it did not:

351. 186 Minn. 611, 244 N.W. 281 (1932) (emphasis added).

In no proper view were the two Minnesota copper companies *selling* the Arizona copper mines. Their intention was to keep them and develop the Shattuck Denn. In effect the property of the Shattuck Arizona was to furnish the means of financing. No money passed or was intended to pass.

. . . .

[The Corporation] might have sold . . . because it was a business-like thing to do. It did not.³⁵²

It might be argued that even though a stock-for-assets transaction would not normally be called a sale if it were simplified as far as it is in the example, it is usually *called* a sale by the parties, or at least by their lawyers, when it is not so simplified. In fact, however, such transactions are usually not called "sales," but rather (albeit for tax purposes) "reorganizations." And even where the term "sale" is used, the very purpose of the characterization may be to eliminate appraisal and voting rights, that is, the term may be consciously used in a self-serving manner.

A more persuasive argument is that regardless of what such a transaction is usually called, "sale" is a very broad term,³⁵³ and at least some of its meanings can encompass stock-for-assets transactions. For example, section 2(3) of the Securities Act of 1933 provides that, "The term 'sale' [or] 'sell' . . . shall include every . . . disposition of . . . a security or interest in a security, for value;"³⁵⁴ and the SEC's Rule 133 provides that for purposes of the 1933 Act's registration provisions *only*, "no 'sale' . . . shall be deemed to be involved so far as the stockholders of a corporation are concerned where . . . there is submitted to the vote of such stockholders . . . a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person" ³⁵⁵

Since we have already seen that a stock-for-assets transaction can be deemed a merger, if the argument that it may be deemed a sale is

352. 186 Minn. 611, 629-30, 244 N.W. 281, 288-89 (1932) (emphasis added); see *Whicher v. Delaware Mines Corp.*, 52 Idaho 304, 15 P.2d 610 (1932); *William B. Riker & Son Co. v. United Drug Co.*, 79 N.J. Eq. 580, 82 Atl. 930 (Ct. Err. & App. 1912). *But see Hill v. Page & Hill Co.*, 198 Minn. 30, 268 N.W. 705 (1936), *rehearing denied*, 198 Minn. 34, 268 N.W. 927 (1936).

353. *Cf. Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967); Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3). For a discussion of similar problems in the context of the sales tax, see Sato, *supra* note 294, at 469-76, 483-85.

354. Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3).

355. SEC Rule 133, 17 C.F.R. § 230.133 (1968).

accepted, it would follow that in the absence of clear statutory guidelines such a transaction could be deemed either a merger or a sale. Which characterization should be applied must then depend on which would best reconcile the overlapping merger and sale provisions and best effectuate the apparent statutory purpose.

One way to approach this problem is syntactical. The term "sale" can be construed to include all stock-for-assets transactions only if it is used in its widest possible sense. However, in its widest possible sense the term encompasses even classical mergers (mergers so denominated) since a classical merger is only a special case of a stock-for-assets transaction. This gives some indication that in the corporate statutes the term "sale" is used in its narrower, more usual connotation, to include only complete dispositions.

A second approach to the problem is through a reading of the apparent statutory purpose. It yields the same result. The merger provisions are intended to protect shareholders as a body (by requiring shareholder vote) and minority shareholders (by requiring two-thirds vote and by providing for appraisal). Since a stock-for-assets combination and a merger are virtually identical in their economic effect on the transferor's shareholders as a body, and on minority shareholders, a stock-for-assets transaction may be deemed a sale only if it is assumed that the legislature intended to accord different treatment to shareholders in two transactions which affected them identically—a construction which would make but little sense and is therefore to be avoided in the absence of language clearly indicating such an intent.

It might therefore seem that the better statutory construction would be to treat all stock-for-assets transactions as mergers under a continuity of interest test. But under most,³⁵⁶ although not all,³⁵⁷ statutes there is a seemingly dispositive objection to this solution, for most sale-of-substantially-all-assets provisions explicitly contemplate transfers of assets in exchange solely for stock of the survivor. For example, the Illinois Business Corporation Act provides that, "A sale . . . of all, or substantially all, the property and assets . . . of a corporation . . . may be made upon such terms and conditions and for such consideration, which may consist, in whole or in part, of money or property . . . including shares of any other corporation

356. See, e.g., CAL. CORP. CODE §§ 3901, 3903 (West 1955); DEL. CODE ANN. tit. 8, § 271 (1967); N.J. STAT. ANN. § 14A:10-11 (Supp. 1968); N.Y. BUS. CORP. LAW § 909 (McKinney 1963); ABA MODEL BUS. CORP. ACT ANN. § 72 (1960).

357. See, e.g., FLA. STAT. ch. 608, § 608.19 (1965); KAN. GEN. STAT. ANN. § 17.3801 (1964); MD. ANN. CODE art. 23 § 9(5) (1966).

. . . as may be authorized [in the specified manner].”³⁵⁸ Under such a statute it would seem impermissible to say that a stock-for-assets transaction is not a sale just because it is made solely for stock.

(B) *The “indicia of a merger” test.*—A second possible line of solution, which obviates this problem, is to distinguish between those stock-for-assets transactions which do not involve any additional element—“without more,” to use the language of *Farris*—and those which are accompanied by some other indicia of a merger, such as a requirement that the transferor dissolve (lose its corporate identity), or an assumption by the survivor of the transferor’s liabilities. This approach has been criticized on the ground that an assumption of the transferor’s liabilities merely constitutes additional consideration for the assets received, while dissolution of the transferor is “frequently, if not usually” an incident of a stock-for-assets transaction.³⁵⁹ But although it is certainly true that many transfers by business organizations which would normally be called sales involve an assumption of liabilities (for example, a transfer of real property for cash plus an assumption of a mortgage), few if any involve a requirement that the transferor dissolve. If such a requirement is “frequently, if not usually” an incident of a stock-for-assets transaction, that may simply indicate that such transactions are “frequently, if not usually” mergers within the meaning of the statute.

358. ILL. ANN. STAT. ch. 32, § 157.72 (1954).

Although we have been focusing on the term “sale,” it should be noted that the statutes typically use a string of terms, such as “sale, lease or exchange,” see DEL. CODE ANN. tit. 8, § 271 (1967); “sale, lease, exchange or other disposition,” see PA. STAT. ANN. tit. 15, § 1311 (1967); N.J. REV. STAT. § 14A:10-11 (Supp. 1968); N.Y. BUS. CORP. LAW § 909 (McKinney 1963); cf. ILL. ANN. STAT. ch. 32, § 157.72 (Smith-Hurd 1954), ABA MODEL BUS. CORP. ACT. ANN. § 72 (1960); or “lease, sale, exchange, transfer, or other disposition,” see OHIO REV. CODE ANN. tit. 17, § 1701.76 (1964); cf. CAL. CORP. CODE § 3901 (West 1955). In context, however, the terms “exchange” and “transfer” seem to be variants of the term “sale,” in the sense that they contemplate a disposal of the corporation’s interest in its assets for consideration. This is most strongly evidenced by the fact that the syntax of most provisions shows that all of the terms are deemed to be within the general class “dispositions.” The apparent purpose of the added terms is to pick up dispositions for consideration other than cash, that is, barter-type transactions. Cf. Treas. Reg. § 1.1001-1(a) (1957) (“Except as otherwise provided . . . the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained” [emphasis added]); FULLER & BRAUCHER, BASIC CONTRACT LAW 804 (1964) (“the word ‘sale’ is used [in the Statute of Frauds] in a broad sense that includes barter or exchanges”). No attempt seems to have been made, either in the courts or in the literature, to argue that, as used in these provisions, the terms “exchange” or “transfer” are broader than the term “sale” (except perhaps as applied to barter transactions), and indeed the cases and commentators seem to universally assume that they are not, for the statutes are invariably characterized as governing the sale of assets.

359. 59 COLUM. L. REV. 366, 370 (1959).

A more serious problem with the indicia test is that it seems unwise. A major criticism of the *Farris* line of cases is that they are "unsettling to the security of transactions . . . for no objective standard is available for measuring a proposed transaction in advance."³⁶⁰ One answer to this, of course, is that the uncertainty is caused not by the courts, but by the legislature, first in using overlapping and ambiguous terms, and then in not resolving the ambiguity when the problem became apparent. Nevertheless, certainty should be an objective of corporate law if it can be attained with a decent regard to fairness. If a merger/sale test depended solely on the presence or absence of various "indicia" of a merger, the zone of uncertainty would seem unduly large.

Furthermore, a test based solely on continuity of interest plus other indicia of a merger may not be entirely justified as a matter of statutory interpretation, since it would pick up transactions in which the relative size of the two constituents is extremely disparate.³⁶¹ As the tax and accounting materials suggest, it may be doubted whether such transactions should properly be deemed mergers rather than sales. Reverting to the hypothetical transfer by *A* to the existing corporation *AB*, if the business of *AB* is so much larger than *A*'s that *A* receives only a negligible interest in *AB*—for example, if *A*'s business consists of two grocery stores and *AB* is a national chain of supermarkets 100 times as large—both laymen and lawyers probably would say that *A* had "sold" his business.³⁶² This is so because while *A* retains a continuity of interest in his former assets, *A*'s stake in *AB* as a whole, and in his former assets in particular, is so small that for all practical purposes *A* has parted with his entire interest in his former business, or, more accurately, has parted with substantially all of that interest.

(C) *A test based on continuity of interest and relative size.*—These problems, together with the tax and accounting experience, suggest the advisability of a third line of solution for reconciling the merger and sale-of-substantially-all-assets provisions, and minimizing the problem of uncertainty and statutory interpretation raised by the second: a relative size test. If the transferor's shareholders retain not only a continuity of interest, but a substantial proportionate stake in the reconstituted enterprise, the transaction should be deemed a merger; if not, it should be deemed a sale. But what constitutes a substantial stake? Although the corporate cases have not addressed themselves to

360. Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1276.

361. Cf. 59 COLUM. L. REV. 366, 372 (1959).

362. See B. BITTKER & J. EUSTICE, *supra* note 329, at 499-500.

this question, the courts are nevertheless not without guidelines. The tax materials tend to indicate that the retention of a 20 percent interest (that is, the receipt by the transferor's shareholders of 20 percent of the stock in the reconstituted enterprise) is necessary if the stake is to be considered substantial.³⁶³ The accounting materials indicate that the receipt of a five to ten percent stake is necessary.³⁶⁴ As we shall see below, other sources, including statutes, have recognized 15-20 percent as a cutoff for closely related purposes.³⁶⁵ These figures appear to set the boundaries of the zone of uncertainty. If the transferor's shareholders receive less than a five percent stake in the reconstituted enterprise, the transaction should be deemed a sale within the meaning of the statute. If the transferor's shareholders receive more than a 20 percent stake in the reconstituted enterprise, the transaction should be deemed a merger. If the stake received by the transferor's shareholders falls in the zone between these boundaries, the court might properly take into account the presence or absence of other indicia of a merger.

This line of solution reconciles the merger and sale-of-substantially-all-assets provisions by giving each of them a scope in sensible conformity to the normal meaning of the terms employed. Not incidentally, it is drawn along lines which (when applied to the survivor, as discussed in the next section) separate out transactions according to their economic significance, and go some way towards an eventual reconciliation of the tax, accounting, and corporate law treatment. While the solution still leaves some uncertainty, the zone of uncertainty is considerably narrowed, since as applied to most transactions the test is a quantitative one; in any event, it is difficult to see how all uncertainty could be eliminated short of statutory reform.

(D) *A statutory solution.*—The problems considered in this section arise only when the relevant statute differentiates, in terms of shareholder rights, between a sale of substantially all assets and a merger. As we have seen,³⁶⁶ many statutes do just this, either by providing that a sale requires only majority approval while a merger requires two-thirds approval, or by providing that a merger gives rise

363. See text accompanying notes 325-40 *supra*.

364. See text accompanying notes 341-50 *supra*.

365. See the rules of the New York and American Stock Exchanges discussed in the text accompanying note 399 *infra*, the Delaware, Ohio, and Pennsylvania small-scale merger statutes discussed in the text accompanying notes 375-97 *infra*, and the SEC test of materiality discussed in the text accompanying note 480 *infra*.

366. See text accompanying notes 206-10 *supra*.

to appraisal rights while a sale does not, or both. This discrepancy of treatment does not seem justified where the consideration for a transfer is stock of the transferee,³⁶⁷ since in that case the economic effect of the two transactions on the transferor's shareholders is virtually identical. The question is then raised, how should the two transactions be treated by the legislature?

If one corporation transfers substantially all of its assets for stock in another, from the perspective of the transferor's shareholders the result is a radical reconstitution of the enterprise, since such shareholders end up owning stock in a new enterprise which by hypothesis consists only in part of the transferor's business.³⁶⁸ Viewing such transactions in light of the considerations discussed in connection with the normative models developed above, such transactions involve a permanent and economically substantial change in the nature of the enterprise; require investment, rather than purely business skills, for their formulation; usually take a relatively long time to consummate; and occur but infrequently in the life of an enterprise. Such transactions should therefore be considered structural, whether denominated mergers or sales, and the approval of the transferor's shareholders—and specifically, of two-thirds of such shareholders—should be required. Furthermore, because of the radical nature of the economic change in the enterprise, and its continuing effect, it would seem appropriate to give dissenting shareholders appraisal rights. This indeed has been the long-term statutory trend, a number of states, including Pennsylvania, having added appraisal rights to their sale-of-substantially-all-assets provisions within the last thirty years.³⁶⁹

(ii) *Shareholders of the survivor in stock-for-assets combinations.*—A stock-for-assets transaction raises somewhat different questions when viewed from the perspective of the survivor than when viewed from the perspective of the transferor. First, in statutory terms the issue is not whether the transaction is a merger or a sale, but whether the

367. Cf. Ballantine & Sterling, *Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California*, 27 CALIF. L. REV. 644, 672-73 (1939); Hills, *supra* note 284, at 366; Lattin, *supra* note 314, at 315-16; Skoler, *Some Observations on the Scope of Appraisal Statutes*, 13 BUS. LAWYER 240, 243 (1958).

368. This assumes the transaction is not an "upside-down" one, involving a camel transferor and a gnat transferee. Such transactions can be handled by treating them as if the gnat were the transferor. See text accompanying notes 375-77 *infra*.

369. See Manning, *The Shareholder's Appraisal Remedy*, *supra* note 34, at 256; Skoler, *supra* note 367, at 243; Note, *Sale of Assets: Dissenting Shareholders' Appraisal Right in Absence of Appraisal Statute*, 46 CALIF. L. REV. 283 n.6 (1958). *But cf.* N.J. REV. STAT. § 14 A: 11-1 (1)(b)(i) (Supp. 1968).

transaction is (1) a merger, on the one hand, or (2) a purchase of the transferor's assets, or an issue of the survivor's stock, on the other. We shall begin by considering the difference in result this might make.

(A) *Stock-for-assets combinations viewed as purchases.*—One way to view a stock-for-assets transaction from the survivor's perspective is as a purchase of assets for stock. This would correspond to the view of such a transaction as a sale from the transferor's perspective, but raises different problems, because the traditional corporate statutes give markedly different treatment to purchases and sales. While the sale-of-substantially-all-assets provisions are invariably elaborate, almost invariably require approval by the transferor's shareholders, and frequently give such shareholders appraisal rights, the provisions relating to purchases are short and simple, normally being found among a relatively long list of corporate powers and giving no indication of whether the power is exercisable by shareholders or directors.³⁷⁰ As a result, these provisions leave room for certain arguments that cannot easily be applied in the case of the transferor. For example, in considering the combination problem from the transferor's perspective, we saw that one reason for not treating all stock-for-assets combinations as mergers is that most sale-of-substantially-all-assets provisions explicitly contemplate the use of stock as consideration. This difficulty is not present where the transaction is viewed as a purchase, because the statutory provisions normally do not explicitly contemplate the use of stock to make a purchase. Similarly, the sale-of-substantially-all-assets provisions are highly elaborated, and seem to occupy the field as far as the rights of the transferor's shareholders are concerned (assuming the transaction is a sale). But the purchase provisions are simple in the extreme, normally are not addressed to the question of how the power is to be exercised, and therefore leave room for the argument that even if a stock-for-assets combination is a purchase it nevertheless requires shareholder approval under common-law principles.³⁷¹

(B) *Stock-for-assets combinations viewed as an issuance of stock by the survivor.*—Another way to view a stock-for-assets transaction from the survivor's perspective is as an issue of stock by the survivor, with the consideration being the assets in question. Again, this raises

370. See, e.g., CAL. CORP. CODE § 802(a) (West 1955); DEL. CODE ANN. tit. 8, § 122(4) (1967); ILL. ANN. STAT. ch. 32, § 157.5(d) (1954); N.J. STAT. ANN. § 14 A: 3-1(d) (Supp. 1968); N.Y. BUS. CORP. LAW § 202(a)(4) (McKinney 1963); OHIO REV. CODE ANN. tit. 17, § 1701.13(F)(1) (1964); ABA MODEL BUS. CORP. ACT ANN. § 4(d) (1960). But see PA. STAT. ANN. § 1302 (1967).

371. Cf. Note, 72 HARV. L. REV. 1132, 1139-40 (1959).

a different set of statutory problems. The statutory provisions governing the issue of stock fall into two patterns: Some empower the board to issue stock; others are silent as to the power to issue stock and simply empower the board to fix the consideration for which the stock is issued.³⁷² At least under a statute employing the former pattern, if a stock-for-assets transaction is viewed as an issue of stock, an argument that the transaction requires shareholder approval involves considerable difficulties.³⁷³

(C) *Stock-for-assets combinations viewed as mergers.*—Finally, such transactions may be viewed as mergers, since from the survivor's perspective, as from the transferor's, a stock-for-assets transaction involves a fusion of two corporations through the issuance of stock by one.

(D) *A suggested solution under the traditional statutes.*—The net result is that at least three treatments of such transactions may be justified under the traditional statutes. Which treatment is employed must therefore depend on which will best reconcile the overlapping statutory provisions and best effectuate the apparent statutory purpose. This in turn indicates the desirability of a relative-size solution. Where the reconstitution of ownership interests is economically insignificant from the survivor's perspective, neither usage nor policy indicates that the transaction should be deemed a merger rather than a purchase under the statutes, or should require shareholder approval under common law principles; where the reconstitution is economically significant, both usage and policy indicate that the transaction should be deemed a merger under the statutes.³⁷⁴ The test for economic significance should be similar to

372. See statutes cited in notes 292 and 293 *supra*.

373. See text accompanying notes 429-50 *infra*.

374. Frequently a stock-for-assets combination is submitted to the survivor's shareholders even when counsel is of the opinion that it is not a merger. Sometimes, as in the *Farris* and *Rath* cases, shareholder approval is required for a particular aspect of the combination, such as a reconstitution of the survivor's board or an amendment of the survivor's certificate to authorize additional shares or a new class of stock. Strictly speaking, in such cases the survivor's shareholders vote only on the particular aspect involved, not on the combination itself. In practice, however, management would usually disclose the purpose of the vote—indeed, if the proxy solicitation is subject to the SEC's proxy rules, management must do so, *cf.* Schedule 14A, Item 20, so that a vote in favor of the aspect in question will therefore often be tantamount to a vote in favor of the combination.

Sometimes, as in the *Appelstein* case, the transaction is submitted to shareholders because the stock to be issued constitutes more than 20 percent of the survivor's outstanding stock and cannot be listed on the New York or American Stock Exchanges unless the transaction is approved by shareholders. See text accompanying note 399 *infra*. Sometimes, the transaction is submitted to shareholders because it was not negotiated at arm's length, or because management

that suggested in the case of the transferor; that is, a test based on the proportionate amount of common stock issued or issuable by the survivor as the result of the transaction.

(E) *New statutory solutions.*—Since these problems only arise in the absence of specific statutory treatment, the question remains how legislatures should treat stock-for-asset acquisitions from the survivor's perspective. Looking at this question in light of the considerations developed in connection with the normative model, the answer should turn on the economic significance of the transaction to the survivor, which in turn will be largely a function of the relative size of the survivor and the transferor. If the transferor is relatively large in proportion to the survivor, the transaction will constitute an economically significant restructuring of the enterprise, both in terms of the effect on the enterprise itself and the consequent reallocation of ownership interests. (What constitutes "relatively large" would be a matter for legislative judgment; in light of the factors discussed in the previous section, a figure in the area of 5-20 percent would seem reasonable.) At the same time, such a transaction would also meet the other criteria for assigning a matter to the shareholders: Formulation of the decision will involve investment rather than purely business skills; the transaction (again assuming it is economically significant) is likely to take a long time to mature in any event; and such transactions are of but infrequent occurrence. Furthermore, the restructuring involved in such cases appears sufficiently radical to grant appraisal rights to dissenters. Where, however, the transferor is small in relation to the survivor, the matter appears appropriate for board decision, and should not give rise to appraisal rights: Such transactions are unlikely to have a high degree of economic significance, and in many cases they are more likely to resemble expansion of the enterprise along existing lines than a restructuring of the enterprise; furthermore, the reallocation of ownership interests would not be, by hypothesis, significant.

Correspondingly, since a classical merger is simply a special case of a stock-for-assets transaction, such a merger should not require approval by the survivor's shareholders, or give such shareholders appraisal rights, unless it falls within a relative-size test or makes a change which should otherwise require shareholder approval or give rise to appraisal rights, such as a significant change in the survivor's certificate (in which case the rules governing the particular change should be applicable).

submits important transactions to shareholders as a matter of principle. See *Heilbrunn v. Sun Chemical Corp.*, 38 Del. Ch. 321, 150 A.2d 755 (Sup. Ct. 1959) and text accompanying notes 437-40 *infra*.

So far, we have been examining the traditional corporate statutes which have not addressed themselves to the problems in question. However, recent statutory amendments in several states, including Pennsylvania, Delaware, and Ohio, have touched to a greater or less degree on the problems posed by stock-for-assets combinations from the survivor's perspective.

(1) *Pennsylvania*.—In 1957 the Pennsylvania Bar Association's corporation law committee prompted the Pennsylvania legislature to amend Pennsylvania's business corporation law in order to overrule two lower-court cases which granted appraisal rights in stock-for-assets transactions, only to learn in *Farris v. Glen Alden* that the language of the amendments did not do the job. Thereafter the committee recommended new amendments, which were enacted in 1959. The amended sale-of-substantially-all-assets section, as it now reads, provides that the shareholders of a corporation

which acquires by purchase . . . substantially all of the property of another corporation by the issuance of shares . . . with or without assuming the liabilities of such other corporation, shall be entitled to [appraisal rights] *if, but only if*, such acquisition shall have been accomplished by the issuance of voting shares . . . to be outstanding immediately after the acquisition sufficient to elect a majority of the directors. . . .³⁷⁵

An amendment to the merger section was comparable.

To appreciate the thrust of the 1959 amendments, we must return to *Farris*. The Pennsylvania statutes in effect when *Farris* was decided gave the shareholders of both constituents voting and appraisal rights in the case of a merger, while in the case of a sale of substantially all assets it gave such rights only to the shareholders of the transferor. The transaction in *Farris* was nominally a sale of substantially all assets, and the complainants were shareholders of Glen Alden, the nominal purchaser. Their principal argument was that they were entitled to appraisal rights because the transaction was really a merger. Most of the opinion was devoted to this argument, which the court accepted.

But the complainants also had a second string to their bow. They argued that even if the transaction was a sale of substantially all assets, in reality Glen Alden was not the purchaser but the seller, so

³⁷⁵ PA. STAT. ANN. tit. 15, § 1311(f) (1967) (emphasis added). As originally enacted, this provision turned on the issuance of "more than a majority of the voting shares of such corporation." In 1963 the provision was amended to make its operation turn on the issue of shares sufficient to elect a majority of the directors. See Historical Notes to PA. STAT. ANN. tit. 15 § 1311 (1967).

that Glen Alden shareholders would be entitled to appraisal even under the sale-of-substantially-all-assets provision. Clearly the facts supported this argument, because Glen Alden's shareholders were to end up with only 23.5 percent of List-Alden's stock, while List's shareholders were to end up with 76.5 percent, and List directors were to have control of List-Alden's board. Clearly also this argument was easier to uphold than the argument that the transaction was a merger, because it did not conflict with the apparent intention of the 1957 amendments to deny appraisal rights to the survivor's shareholders in any stock-for-assets combination denominated as a sale.³⁷⁶ And in fact the court adopted this argument, but only as an alternative holding which it set out in two sentences at the end of the opinion, and the significance of which it seemed at pains to minimize.³⁷⁷

Why did the court choose to rest its opinion basically on the harder-to-defend position that the transaction was a merger? One possibility is simply that the court regarded the transaction as a merger and not as a sale, and did not want to take an easy way out simply to cut down criticism—particularly since to have done so would have left planners of stock-for-assets combinations without guidelines as to how the court would treat such a combination when the survivor's shareholders emerged with a majority of the stock in the reconstituted enterprise. A second possibility is a bit more complex. At the time of *Farris* the Pennsylvania statute, like many others, gave appraisal and voting rights to the shareholders of both corporations in the case of a merger, but only to the shareholders of the selling corporation in the case of a sale of assets.³⁷⁸ Therefore, if a

Actually, even the 1959 amendments are not as clear as they could be, since they continued to use the term "purchase" without defining it. See D. HERWITZ, BUSINESS PLANNING 722 (1966).

376. See 47 CALIF. L. REV. 180, 186 (1959), and 59 COLUM. L. REV. 366, 370-71 (1959), disapproving the principal ground of decision in *Farris* but approving the alternative holding; cf. 51 IOWA L. REV. 1096, 1104-05 (1966), taking a comparable position on the *Rath* case.

377. "Even were we to assume that the combination . . . is a 'sale of assets' . . . it would avail the defendants nothing; we will not blind our eyes to the realities of the transaction. Despite the designation of the parties and the form employed, Glen Alden does not in fact acquire List, rather, List acquires Glen Alden"

"We hold that the combination contemplated by the reorganization agreement, although consummated by contract rather than in accordance with the statutory procedure, is a merger within the protective purview of [the merger and appraisal provisions]." 393 Pa. at 438, 143 A.2d at 31 (1958).

It is striking that the *Rath* court, which might have used a realignment approach (the transaction involved the issue by *Rath* of common and convertible preferred; assuming full conversion of the preferred, Needham shareholders would have ended up with 54 percent of the reconstituted corporation's outstanding common), also did not do so. See 51 IOWA L. REV. 1096, 1104-05 (1966); cf. *Applestein v. United Bd. & Carton Corp.*, 60 N.J. Super. 333, 352, 159 A.2d 146, 156 (Ch. 1960) *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1961). But cf. D. HERWITZ, *supra* note 375, at 720.

378. See note 296 *supra*.

court held that the transaction was a sale, but that the parties to the sale had to be realigned, it might give rights to one set of shareholders only by stripping them from the other. Thus in a transaction like *Farris*, if the transaction was a sale and Glen Alden was the seller, must not List be the purchaser? If so, would that not mean that, despite the form of the transaction, the shareholders of List, the "purchaser," would have no appraisal or voting rights under Pennsylvania law? Actually, this was not a problem in *Farris* itself, because List was a Delaware corporation; the rights of its shareholders therefore depended on Delaware law,³⁷⁹ and Delaware did not give appraisal rights to the shareholders of either the purchaser or the seller in a sale of substantially all assets.³⁸⁰ Nevertheless, the court may have been reluctant to rest its decision on a rule of law which might come back to haunt it in a case involving two Pennsylvania corporations.

In any event, the 1959 amendments moved to codify *Farris*'s alternative holding by giving appraisal rights to the shareholders of a corporation which is nominally a purchaser of substantially all assets, but is effectively a seller because it is issuing voting shares sufficient to elect a majority of the directors of the reconstituted corporation. Presumably, the amendments do not realign the corporate parties—that is, the appraisal rights given to shareholders of a nominal purchaser by the amendments are not in derogation of the appraisal rights given to shareholders of a nominal transferor by the sale-of-substantially-all-assets provision itself. To that extent the amendments will in some cases mark an improvement over the exigencies of a case-law approach under the traditional statutes. But on the whole the statute is woefully inadequate and gives rise to highly anomalous results. For example, suppose *P* issues 55 percent of its stock for the assets of *S*. Then one set of shareholders will end up with 45 percent of the stock of the reconstituted corporation, and one set with 55 percent. Both sets will have appraisal rights—*S*'s shareholders under the traditional sale-of-substantially-all-assets provision, and *P*'s shareholders under the 1959 amendments. So far, so good. But now suppose *P* issues only 45 percent of its stock.

379. See 59 COLUM. L. REV. 366, 371 (1959).

380. Delaware did give appraisal and voting rights to shareholders of a transferor in a merger. However, the Pennsylvania court's characterization of the transaction as a merger under Pennsylvania law for purposes of adjudicating the validity of a meeting called by a Pennsylvania corporation would not appear to be determinative of the voting and appraisal rights of shareholders in the Delaware corporation. See note 423 *infra*.

Economically the case seems identical: The two sets of shareholders will end up with 55 and 45 percent of the stock of the reconstituted corporation, respectively. But now only one set (S's) will have appraisal rights, because the 1959 amendments are inapplicable. This is carrying form to a fare-thee-well.

The amendments also present a difficult problem of interpretation. They say nothing about voting rights. Do they nevertheless affect such rights? If so, how?

It can be argued that the amendments exclude voting rights to the survivor's shareholders by negative implication, and there is some independent support for such an argument. The title of the omnibus bill containing the 1959 amendments stated that it was an act, among other things, "abolishing the doctrine of de facto mergers or consolidation and reversing the rules laid down by *Bloch v. Baldwin* . . . and *Marks v. The Autocar Co.* . . ." ³⁸¹ This might have been intended to preclude the courts from treating any transaction as a merger for any purpose unless it was so denominated. But several factors weigh against such an interpretation. First is the conventional rule of statutory interpretation that while the title of a bill can serve as an aid in resolving ambiguities in the enacting language, it cannot extend the effect of the enacting language to a subject it does not cover. ³⁸² The enacting language of the 1959 amendments clearly does not affect voting rights, and it is almost unimaginable that a bar association committee would attempt to affect such rights solely through the medium of a cloudy phrase in the title clause of a bill. More important, when the 1959 amendments were enacted the de facto merger doctrine was seen primarily as a problem of appraisal rights. (The voting problem was not squarely presented in *Farris*, because the transaction was submitted to the survivor's shareholders and received approval sufficient to satisfy the merger statute.) Even today, the commentators often focus almost exclusively on appraisal rights in discussing the combination problem. ³⁸³ It seems probable, therefore, that no consideration was given to voting rights by the draftsmen of the 1959 amendments, and that the reason for the broad language in the title of the bill was simply to insure that the courts would not interpret the appraisal provisions of the 1959 amendments

381. P.L. No. 502, 2 [1959] Pa. P.L. 1406.

382. *Weir v. United States*, 339 F.2d 82, 85 (8th Cir. 1964); *Turer v. Ahavas Achem Anshe, Belleville*, 53 N.J. Super. 175, 147 A.2d 94 (Super. Ct. 1958); *In re State Highway Route No. 72*, 265 Pa. 369, 108 A. 820 (1919); 1 J. SUTHERLAND, STATUTORY CONSTRUCTION § 4802 (3d ed. 1943); cf. *Jones v. Garrod*, 419 Pa. 538, 215 A.2d 902 (1966).

383. See, e.g., *Folk, De Facto Mergers in Delaware*, supra note 235.

in an overly restrictive way, as the draftsmen obviously felt the courts had done in the case of the 1957 amendments. This is pretty clearly indicated by the bar association committee's report:

In order to overcome [the *Farris*] decision the proposed amendment will change slightly the language of [the merger and sale-of-substantially-all-assets provisions] to clarify questions raised by the courts in the *Farris* case. The bill also contains in its title a statement that one of its features is to abolish the doctrine of *de facto* merger or consolidation, and to reverse the decisions of the courts in the *Bloch* and *Autocar* cases. This may seem an extreme measure to demonstrate the intention of the legislature but under legislative practice in Pennsylvania and the decision of the Supreme Court in the *Farris* case no other method of demonstrating such an intention (which the courts would consider) has occurred to the Committee.³⁸⁴

Finally, if the 1959 amendments cut off voting rights to a survivor's shareholders by negative implication, then if *P* issues stock carrying, say, 75 percent of its votes in exchange for assets, the transaction would not require approval by *P*'s shareholders despite the fact that under the 1959 amendments they would have appraisal rights. Calling such a transaction a "purchase" by *P* strains not only language but credulity, and such a result is so unlikely to have been intended by the legislature that it should be based on something more than negative implication. Indeed, it may be argued with perhaps greater persuasiveness that the amendments evince an underlying policy requiring shareholder approval in such a case.³⁸⁵ But probably the soundest approach for the courts to take would be to recognize that the 1959 amendments defy clear application to voting rights, and work out the rules governing voting rights on a case-by-case basis, taking into account the policy evidenced by the 1959 amendments.

(2) *Delaware*.—In 1967 Delaware revised its corporation law. The revised statute did not give voting or appraisal rights to a survivor's shareholders in a stock-for-assets combination, yet it did eliminate the voting and appraisal rights of such shareholders in a small-scale merger. (In 1968 New Jersey and Pennsylvania adopted a substantially identical provision.)³⁸⁶ The Official Reporter of the Committee on the Revision of the Delaware Corporation Law has explained this approach as follows:

384. PA. BAR. ASSOC., 1959 ANNUAL REPORT 152.

385. Cf. Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1285.

386. See text accompanying notes 224-25 *supra*.

When business needs require the acquisition to take the form of a statutory merger rather than a purchase of assets or shares, the merger should not require a shareholder vote or paying off cash to dissenters when other procedures with nearly identical economic consequences do not entail these additional burdens. Stated otherwise, the new law puts mergers more on a parity with acquisition of assets or shares so far as the legal requirements are concerned.

. . . .
 . . . [T]he existence of an appraisal right in a transaction labeled a "merger" may be hard to explain if a similar right is denied in a transaction labeled "sale of assets" or "exchange of shares," when both transactions are economically identical in their impact. Thus, the new law puts mergers and other devices for combining corporations on a parity.³⁸⁷

If, as the Reporter recognizes, stock-for-assets combinations are "economically identical in their impact," with mergers, what possible justification could there have been for failing to grant voting and appraisal rights to a survivor's shareholders in large scale stock-for-assets combinations? The answer is—dollars for Delaware. The vice chairman of the Revision Committee frankly stated the Committee's purpose as follows:

[T]he franchise tax dollar is very important in many states, including Delaware, and when one state hears that a corporation is thinking of transferring to Delaware, for example, but instead has gone to Maryland, the state officials begin thinking of the franchise tax dollar, and frankly, that is one of the reasons for the formation of this committee—to modernize and liberalize the Delaware corporation law.³⁸⁸

387. FOLK, *THE NEW DELAWARE CORPORATION LAW* 32-33, 38 (1967).

388. Corroon, *The Proposed New Delaware Corporation Statute*, 20 J. LEGAL ED. 522 (1968); cf. *Delaware Laws Lure Companies*, N.Y. Times, January 12, 1969, § 1, at 57, col. 1; *More Firms Adopt Delaware as Legal Home to Benefit from Liberal Corporate Law*, Wall St. Journal, April 16, 1968, at 6, col. 2.

Admittedly, the new statute could have been worse. Connecticut provides that a merger does not require approval of the survivor's shareholders unless it makes a change in the survivor's certificate or involves the issues of shares which "could [not] have been issued by the board of directors of the surviving corporation without further" shareholder authorization. CONN. GEN. STATS. ANN. tit. 33, § 33-366(b)(2) (1961). Thus a corporation with 100,000 shares authorized and 10,000 shares issued can engage in a merger involving the issuance of 90,000 shares (nine times the number then outstanding) without shareholder approval, as long as it is the survivor. Yet if the same corporation engages in a merger in which it is not the survivor, or if it is the transferor in a stock-for-assets transaction, shareholder approval will be required although its shareholders may end up with, for example, half of the stock of the reconstituted corporation. See CONN. GEN. STAT. ANN. tit. 33 § 33-372 (1961). Nor does the statute's peculiarity end with voting rights. Connecticut also provides that whether the transferor's

(3) *Ohio*.—In 1963 Ohio amended its corporate statute to provide that a stock-for-assets combination requires the approval of the survivor's shareholders and gives such shareholders appraisal rights, if the shares issued by the survivor carry "one-sixth or more of the voting power . . . in the election of directors immediately after the consummation of such transaction" (which is equivalent to 20 percent of the voting power immediately prior to the combination).³⁸⁹ At the same time, the merger sections were amended to provide that a merger does not require approval of the survivor's shareholders unless the one-sixth test is met or the merger agreement makes a change in the survivor's certificate, by-laws, or board;³⁹⁰ and does not give such shareholders appraisal rights unless the one-sixth test is met or the merger effects a change in the survivor's certificate that constitutes an independent ground for appraisal rights under the Ohio statute.³⁹¹ The corporation law committee of the Ohio State Bar Association, which drafted the new provisions,³⁹² commented as follows on the reason for this treatment:

Although there are legal and tax distinctions between an acquisition of assets and a merger . . . the business and financial world treat them as the same in substance. Moreover, the courts in other states have held that the merger statute may apply to an acquisition of assets on the theory of de facto merger where the relatively large size or different nature of the business of the acquired corporation is such that the shareholder's investment in the acquiring corporation becomes a new investment in a different enterprise. . . . In the absence of a statutory definition of where the line falls, it is difficult, under the doctrine of these cases, to apply to many factual situations such distinctions of [as ?] relative size of the corporations, relationship of their business, and control.

It is the intent of the new section . . . to avoid in Ohio any such

shareholders have appraisal rights in a typical stock-for-assets transaction depends on whether the transaction is "substantially equivalent to a merger," *id.* § 33-373(d), but gives no guidelines as to how that determination shall be made. All this is particularly difficult to understand in a state like Connecticut, in which the prototypical corporation is undoubtedly the privately held one, while the impression is strongly conveyed that in drafting the statute the legislature had in mind the giant publicly held corporation.

389. OHIO REV. CODE ANN. tit. 17, §§ 1701.01(Q), 1701.84(A)(2) (D) (1963). The legislative technique involves a statutory definition of a "combination" as the issuance of "voting shares . . . in consideration in whole or in part for the transfer . . . of all or substantially all the assets of one or more corporations."

390. OHIO REV. CODE ANN. tit. 17, § 1701.79(A) (1963).

391. *Id.* § 1701.81(B).

392. OHIO REV. CODE ANN. tit. 17, at 5 (1963).

problems of interpretation and any such possibility of de facto merger, by adopting . . . specific statutory quantitative test[s]³⁹³

The general principles reflected in the statute seem eminently sound. However, the execution is open to criticism. The statutory language follows that of the 1959 Pennsylvania amendments by adopting a test based on voting power "immediately after" consummation of the transaction. Assuming that "immediately after" means what it says,³⁹⁴ this test fails to deal adequately with securities which are nonvoting when issued but are convertible into voting stock.³⁹⁵ Since convertible securities are extremely prevalent in today's market,³⁹⁶ and are commonly used to effectuate corporate combinations, a statute which employs a voting-power test should take such securities into account, preferably by assuming full conversion. (In the *Rath* case, which involved convertible stock, the Iowa court analyzed the transaction on just such a basis.³⁹⁷)

But more fundamentally, it is open to question whether a voting-power test should be used at all. Suppose *S* corporation whose authorized stock consists of 200,000 shares of Class A voting common, 100,000 shares of Class B nonvoting common, and 100,000 shares of nonvoting preferred which is convertible into Class A voting common

393. Committee Comment to *id.* § 1701.84.

394. See McDonough, *supra* note 235, at 26-27 n.41.

395. Suppose, for example, that the authorized stock of Corporation *S* consists of 200,000 shares of Class A voting common, 100,000 shares of Class B nonvoting common, and 100,000 shares of nonvoting preferred which is convertible into Class A voting common on a one-to-one basis; and that of these authorized shares, 100,000 shares of Class A common are issued and outstanding. Under the Ohio statute, if *S* acquires substantially all of the assets of Corporation *T* by issuing 20,500 shares of Class A common, *S*'s shareholders will have voting and appraisal rights, since the 20,500 Class A shares will carry one-sixth of the voting power "immediately after the transaction." But if *S* instead issues 19,500 shares of Class A common and 80,500 shares of preferred, *S*'s shareholders presumably will not have voting or appraisal rights since the preferred is nonvoting and the 19,500 shares of Class A will not carry one-sixth of the voting power. This, despite the fact that if all the preferred is converted the shares issued to *T* will account for 50 percent of total voting power.

396. See Fleischer & Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 474 (1961). The authors state that as of 1961 convertible issues represented nearly one-tenth of all financing through bonds and preferred stock. They add, "An analysis of public offerings of securities for the years 1933 to 1952 revealed that over nine percent of the bonds offered were convertible, while some thirty-five percent or more of preferred stock had some conversion feature. . . . [A] recent survey concluded that roughly half the preferred stock offered to public during 1959 and the first half of 1960 contained a conversion privilege." *Id.* at 476.

397. This approach is also taken by the rules of the New York and American Stock Exchanges, discussed in the text accompanying notes 399-400 *infra*.

on a one-to-one basis. Of these authorized shares, 100,000 shares of Class A common are issued and outstanding. The corporation then issues 100,000 shares of Class B nonvoting common. The transaction will involve 50 percent of the outstanding common stock, and therefore 50 percent of the claims on residual earnings, but under the Ohio statute S's shareholders would not have voting or appraisal rights, because the Class B stock is nonvoting. It would seem sounder to adopt a test based on the ownership interests (stock) issues, rather than on voting power involved. The chief problem with such a solution is that in large corporations ownership interests tend to be divided into various classes, which are not necessarily fungible, and shares of stock are therefore not as easily quantifiable as voting power. One way to approach this problem is to use the Delaware test for small-scale mergers, which turns on whether shares of stock of *any class* issued by the survivor exceed 15 percent of the shares of that class theretofore outstanding. Another way is to adopt a test turning on the proportionate amount of shares of common stock issued or issuable as a result of the transaction.³⁹⁸

If such a test were adopted, it would be desirable to apply it whenever the requisite amount of stock was issued in exchange for business assets. Both the New York and American Stock Exchanges have already adopted such a test, by requiring shareholder approval as a prerequisite to the listing of stock which is issued in connection with

[t]he acquisition, direct or indirect, of a business, a company, tangible or intangible assets or property or securities representing any such interests. . . . Where the present or potential issuance of common stock or securities convertible into common stock could result in an increase in outstanding common shares approximating 20% or more.³⁹⁹

Such a rule eliminates the distinction between an acquisition of substantially all of another corporation's assets and an acquisition of less than substantially all such assets, as well as the distinction between combinations with corporate and noncorporate enterprises. From the perspective of the survivor's shareholders these distinctions are irrational, because the economic significance of a combination to the survivor depends essentially on the number of shares issued, the

398. Cf. Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 944-45 (1966).

399. NEW YORK STOCK EXCHANGE, COMPANY MANUAL at A-284(3) (1968); see also CCH, AMERICAN STOCK EXCHANGE MANUAL at 8973 (1966). The term "common stock" is somewhat ambiguous; it might be defined to mean stock entitled to share in corporate distributions on other than a fixed percentage or dollar basis.

character of the assets for which they are issued, and the persons to whom they are issued—not on whether the assets happen to comprise 60 percent or 90 percent of the transferor's assets, or whether the persons receiving the stock had theretofore held the assets through a corporation rather than through a partnership. Such a test would also facilitate planning because it is strictly quantified, while a rule based on whether substantially all of the transferor's assets are involved raises difficult questions of interpretation.⁴⁰⁰

(iii) Shareholders of the transferor in stock-for-stock combinations.—

A stock-for-stock combination does not require corporate action by the transferor, since it is effected through the transfer of stock by the transferor's shareholders on an individual basis. From the transferor's perspective, therefore, such a combination presents radically different problems than a stock-for-assets combination, which does require corporate action. If the transferor's shareholders transfer all their stock, no problem of voting or appraisal rights is raised. Suppose, however, that less than all of the stock is transferred and that the transferor continues in existence as the survivor's subsidiary. Since the two corporations are not completely fused, and the transferor retains its own assets, the transaction does not seem to be either a merger or a sale of substantially all assets from the transferor's perspective.⁴⁰¹ Under the traditional statutes the nontransferring shareholders would therefore have neither voting nor appraisal rights. Nor would voting rights seem desirable in such cases. For one thing, by its very mechanics the transaction requires shareholder approval of sorts, because the combination cannot take place unless a sufficient number of the transferor's shareholders agree to exchange their shares for stock in the survivor. More important, it would seem unwise to give the shareholders as a body a right to vote on whether some shareholders can sell their stock, and it would seem virtually impossible to develop a mechanism pitched to that objective without placing an inordinate restriction on the normally free alienability of shares.

400. See text at notes 457-68 *infra*.

401. See *Mitchell Investment Co. v. Republic Steel Corp.*, 63 F. Supp. 323 (N.D. Ohio 1944), *aff'd mem.*, 152 F.2d 105 (6th Cir. 1945); *Folk, De Facto Mergers in Delaware*, *supra* note 235, at 1283-84; *cf. Architectural Building Products, Inc. v. Cupples Products Corp.*, 221 F. Supp. 154 (E.D. Wisc. 1963) (stock-for-stock transaction not a merger from perspective of transferor's creditors); *Orzek v. Englehart*, 41 Del. Ch. 361, 195 A.2d 375 (Sup. Ct. 1963) (stock-for-stock transaction not a merger from perspective of survivor's shareholders); *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964) (same); *Fidanque v. American Maracaibo Co.*, 33 Del. Ch. 262, 92 A.2d 311 (Ch. 1952) (same). *But cf. Hoche Productions, S.A. v. Jayark Films Corp.*, 256 F. Supp. 291, 295-96 (S.D.N.Y. 1966) (*contra* to *Architectural Building, supra*).

A more difficult question is whether it would be desirable to give the nontransferring shareholders an appraisal right. It is arguable that since the nature and size of the transferor's assets and business, and the nontransferring shareholders' proportionate interest, all remain the same,⁴⁰² it would be unwise or at least unnecessary to give appraisal rights to the nontransferring shareholders, or to put it differently, that it would be neither feasible nor desirable to give appraisal rights merely because of a shift in corporate control.

However, there is a difference between an ordinary shift in corporate control and the acquisition by one corporation of such a substantial stake in another that the latter becomes a mere extension of the former. When individuals acquire corporate control their interest is normally focused on the acquired corporation. This may not be true, however, where control is acquired by another corporation. As Gower puts it:

The [acquired] company's existence is not affected, nor need its constitution be altered; all that occurs is that its shareholders change. From the legal viewpoint this methodological distinction is formidable, but commercially the two things may be almost identical. If . . . a controlling interest is acquired, the [acquired] company . . . will become a subsidiary of the acquiring company . . . and cease, in fact though not in law, to be an independent entity.

. . . .

This may produce the situation in which a small number of dissentient members are left as a minority in a company intended to be operated as a member of a group. As such, their position is likely to be unhappy, for the parent company will wish to operate the subsidiary for the benefit of the group as a whole and not necessarily for the benefit of that particular subsidiary.⁴⁰³

The closer the survivor's proportionate interest in the transferor approaches 100 percent the more likely this is to be true. At the same time, as the survivor's proportionate interest approaches 100 percent the market for the transferor's stock may be thinned almost out of existence.⁴⁰⁴ Indeed, if the transferor is a listed corporation the transaction may result in delisting if the amount of stock which remains outstanding in the public's hands is insufficient to satisfy

402. See Folk, *De Facto Mergers in Delaware*, *supra* note 235, at 1283; Note, 72 HARV. L. REV. 1132, 1144 (1959).

403. L. GOWER, *supra* note 268, at 561 (2d ed. 1957). See also R. MOON, *BUSINESS MERGERS AND TAKE-OVER BIDS*, 138-43 (3d ed. 1968). As an example of such a situation, see *Mitchell Investment Co. v. Republic Steel Co.*, 63 F. Supp. 323 (N.D. Ohio 1944).

404. R. MOON, *supra* note 403, at 140.

minimum Exchange requirements.⁴⁰⁵ At the same time the survivor may, for its own business reasons, cut or even eliminate dividends by the transferor, reinforcing a possible diminution in market price caused by the thinness of the market.⁴⁰⁶ Under such conditions the market price of the stock retained by nontransferring shareholders may fall well below its fair value.

Of course, if the acquisition of the transferor's stock is made through a tender offer open to all the transferor's shareholders, the remaining minority may be said to have voluntarily chosen their fate. This answer does not seem wholly satisfactory, however, because the minority may have legitimately felt that the tender price was below the fair value of their stock. And this answer is not responsive at all where the survivor achieved its position through private purchases on terms unavailable to the minority, or even through gradual purchases on the public market where it has not publicly disclosed its intentions.⁴⁰⁷

Since 1948 the English Companies Act has dealt with at least a portion of this problem. In 1929 there was introduced into the Companies Act a provision, the present section 209(1),⁴⁰⁸ which generally provides that where one corporation holds at least 90 percent of the stock of another as a result of a tender offer the acquiring corporation can compel the remaining shareholders to sell at the tender price.⁴⁰⁹ (On application the court has power to relieve minority shareholders of their obligation to sell, but "except in special circumstances, the onus upon the [minority] shareholder is a heavy one.")⁴¹⁰ The Cohen Committee, appointed by the British Government in 1943 to review the Companies Act of 1929, pointed out in its Report that:

[w]hile a company, if it obtains 90 percent of the shares [for which a tender offer was made] can compel the dissentient minority to sell

405. See Note, 72 HARV. L. REV. 1132, 1142 n.66 (1959). This was apparently the case in *Mitchell Investment Co. v. Republic Steel Co.*, 63 F. Supp. 323 (N.D. Ohio 1944).

406. See R. MOON, *supra* note 403, at 140-42.

407. Under the 1968 amendments to the Securities Exchange Act, the latter course of action cannot be followed if the stock is registered under § 12 of that Act, see text at pages 39-40 *supra*, since a person who becomes the owner of more than 10 percent of such stock must send to the issuer, to the SEC, and to any exchange on which the stock is listed, a statement containing information which would normally reveal any plans to gradually acquire a dominant position. See Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (1964) and the temporary rules and regulations thereunder promulgated in Securities Exchange Act of 1934 Release No. 8370 (1968), as amended in Securities Exchange Act of 1934 Release No. 8392 (1968).

408. The Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 209(1).

409. See M.A. WEINBERG, TAKE-OVERS AND AMALGAMATIONS 143-52 (2d ed. 1967).

410. *Id.* at 155.

their shares, the dissentient minority have no power to compel the company to acquire the shares held by them although their position as a small minority in a subsidiary company may be anything but satisfactory.⁴¹¹

Accordingly, in 1948 section 209(2) was added to the Companies Act, providing that where as a result of a successful tender offer the acquiring corporation has the right to compel minority shareholders to sell their shares under section 209(1), the minority has a reciprocal right to compel the acquiring corporation to purchase their shares at either the tender-offer price or a price fixed by the court.⁴¹²

In many American jurisdictions the short-form merger statutes are a partial analogue to section 209(1) since under a good many of these statutes the parent can force minority shareholders in the subsidiary to take cash for their stock, thereby terminating their interest as effectively as could be done under section 209(1).⁴¹³ And at least one state, New Jersey, has a provision directly modeled upon section 209(1), although it applies only to stock-for-stock tender offers.⁴¹⁴ But no American jurisdiction seems to have an analogue to

411. COMMITTEE ON COMPANY LAW AMENDMENT, REPORT 89 (CMD No. 6659, 1945).

412. M.A. WEINBERG, *supra* note 409, at 158-62.

413. The short-form merger statutes commonly require a merger plan to "state the terms and conditions of the merger, including the securities, *cash* or other property to be issued, paid or delivered by the surviving corporation upon surrender of each share of the subsidiary corporation," DEL. CODE ANN. tit. 8, § 253 (1963), or to state "the manner and basis of converting the shares of the subsidiary corporation into shares or other securities or obligations of the surviving corporation or the *cash* or other consideration to be paid or delivered upon surrender of each share of the subsidiary corporation," MODEL BUS. CORP. ACT ANN. § 68A(b) (1960). (Emphasis added in both cases.) *See also* N.Y. BUS CORP. LAW § 905(a)(3) (McKinney 1963). In *Coyne v. Park & Tilford Distillers Corp.*, 38 Del. Ch. 514, 154 A.2d 893 (Sup. Ct. 1959), the Delaware court held that under such a provision a parent could pay out solely cash, thus completely eliminating minority shareholders. The soundness of this decision as a matter of statutory interpretation is open to question, *see Note, Elimination of Minority Share Interest by Merger: A Dissent*, 54 Nw. U.L. REV. 629 (1959), but it seems likely that other courts will follow, particularly where (as is frequently the case) the relevant short-form merger statute is enacted or reenacted after *Coyne*. In *Beloff v. Consolidated Edison Co.*, 300 N.Y. 11, 87 N.E. 2d 561 (1949), the New York Court of Appeals had before it a situation comparable to that involved in *Coyne*. The plaintiffs launched a broadside constitutional attack against the short-form merger statute, but did not specifically raise the issue whether a total cash payout was permissible as a matter of statutory interpretation. The court upheld the constitutionality of the statute. While the case is not square authority for the proposition that an all-cash payout is permissible as a matter of statutory interpretation, it probably would influence the New York court in that direction if the question should be squarely raised.

414. N.J. REV. STAT. § 14A:10-9 (Supp. 1968). This section permits a New Jersey corporation to "acquire, in exchange for its shares, all the shares, or all the shares of any class or series" of any other New Jersey corporation. To utilize this section the acquiring corporation must submit a written offer to the holders of all the shares to be acquired by first-class mail, specifying the shares to which the offer relates, the terms and conditions of the offer, and the

section 209(2). This is unfortunate, because section 209(2) goes at least part way toward solving the problem of fair treatment to nontransferring shareholders in a stock-for-stock combination and has apparently proved workable over a 20-year course of experience in a major commercial jurisdiction.

There are, however, legitimate questions as to how far such a statute should reach. Some of these questions have been considered by the Jenkins Committee, which was appointed by the British Government in 1959 to review the Companies Act of 1948,⁴¹⁵ and section 209 therefore provides a useful vehicle for considering these issues.

The first question is whether such legislation should be limited to cases where the acquiror is a corporation. The Jenkins Committee recommended retention of this limitation in section 209 on the grounds that the acquiror's right to compel sale should be so limited because it was only intended to facilitate mergers, while "a dissentient minority should not be given rights under section 209 against an individual offeror since the latter could never have powers of compulsory acquisition."⁴¹⁶ It is not clear why the right to compel

rights of such shareholders under § 14A:10-9. If within 120 days the offer has been accepted by at least 90 percent of the shares in question (other than those held directly or indirectly by the offeror), the offeror can compel the remaining minority to sell the balance of the shares at the terms of the offer, or, if a minority shareholder so elects, at the "fair value" of the stock as determined under the New Jersey appraisal provisions.

There are several differences between the New Jersey provision and section 209(1) apart from the fact that section 209(1) relates to all tender offers, while the New Jersey provision relates only to stock-for-stock offers. Thus, section 209(1) permits the minority to apply to the courts for an order relieving them of their obligation to sell, but makes no provision for an application requesting that the price be set by independent appraisal. See COMPANY LAW COMMITTEE, REPORT 106 (CMD No. 1749, 1962) [hereinafter cited as *Jenkins Committee Report*]. The New Jersey provision gives shareholders the right to require appraisal, but not the right to be relieved of their obligation to sell. Section 209(1) is somewhat ambiguous in its treatment of offeree corporations with more than one class of stock, and of offers made to less than all stockholders, or at least less than all of a given class. See *Jenkins Committee Report, supra*, at 105-06. The New Jersey provision eliminates these ambiguities by covering offers for "all the shares, or all the shares of any class or series." Under section 209(1), if the acquiring corporation already owns one-tenth of the shares concerned the offer must be accepted not only by the holders of 90 percent of the remaining shares, but by three-fourths of the remaining number of individual shareholders. This limitation serves no useful purpose, *Jenkins Committee Report, supra*, at 107; M.A. WEINBERG, *supra* note 409, at 152-53, and the New Jersey provision has nothing comparable.

415. As of 1967, only limited portions of the recommendations of the *Jenkins Committee Report*, not including those having to do with section 209, had been the subject of legislative action, but the government had announced its intention to introduce legislation dealing with other of the Report's recommendations during the present Parliament. See S. MAGNUS & M. ESTRIN, THE COMPANIES ACT 1967, 112-13 (1967).

416. *Jenkins Committee Report, supra* note 414, at 105.

purchase should be viewed as strictly reciprocal to the right to compel sale. Nevertheless, limiting the former right to cases where the acquiror is a corporation seems legitimate, since the principal reason for giving minority shareholders such a right is the likelihood that where one corporation acquires a dominant position in another, "the parent company will wish to operate the subsidiary for the benefit of the group as a whole and not necessarily for the benefit of that particular subsidiary."⁴¹⁷

A second question is whether the right of nontransferring shareholders to compel purchase of their stock should be restricted to situations arising out of takeover bids for all of the transferor's stock. Section 209(2) was pretty clearly so intended, although the language is not as clear as it could be. Probably this was for historical reasons: Section 209(1) was designed to apply to takeover bids, and section 209(2) was conceived as reciprocal to section 209(1).⁴¹⁸ Analytically, however, it would seem appropriate to extend a compulsory purchase provision to any situation in which 90 percent control has come to reside in a parent's hand, whether this results from one swooping takeover bid for all of the transferor's stock or from a series of creeping private or public purchases. If the purpose of a compulsory purchase provision is, as the Cohen Committee states, to enable the minority to get out of a position which "may be anything but satisfactory," the way in which the minority got into that position should not be crucial. Indeed the right to compel purchase is even more appropriate when the parent has achieved the triggering percentage by private purchases than by tender offer, because in the latter case the nontransferring shareholders will at least have had an opportunity to sell, while in the former they will not. Extending the compulsory purchase right beyond the tender-offer context would also help insure that acquiring corporations will not pay a premium for corporate control above and beyond the fair value of the acquired corporation's stock. Presumably such a premium will only be paid if the acquiring corporation can make itself whole by taking patronage from or looting the acquired corporation, at the expense of minority shareholders, or by buying out the minority shareholders at a depressed price.⁴¹⁹ An acquiring corporation which had to pay

417. L. GOWER, *supra* note 268, at 561.

418. See *Jenkins Committee Report*, *supra* note 414, at 105; M.A. WEINBERG, *supra* note 409, at 158-59. Weinberg suggests as another possible reason "the difficulty of giving some basis for fixing the price" in the absence of a tender offer. *Id.* at 159.

419. Cf. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Jennings, *Trading in Corporate Control*, *supra* note 63, at 14-19 and *passim*.

minority shareholders the fair value of their shares could not afford to pay such a premium to majority shareholders just to achieve control.

Three arguments might be made against extending compulsory purchase provisions beyond the tender-offer context. First, as long as purchase can be compelled only where the acquiring corporation has made a tender offer for all shares, an acquiring corporation will not have to purchase minority shares unless it has already shown a disposition to do so. If the right to compel purchase is extended beyond tender offers in some cases it will be applicable even though the acquiring corporation does not want all the shares. But if such reasoning were rigorously applied it would eliminate the parent's right to compel the minority to sell, since the minority will not have manifested any such desire—quite the contrary. Moreover, as long as the triggering percentage is kept relatively high, a compulsory purchase is unlikely to be onerous. If the parent has already seen fit to purchase a substantial proportion of the subsidiary's shares, its reasons for not wanting to purchase the balance would usually be well outweighed by the minority's interest in being able to compel purchase.

Second, it could be argued that as long as the right to compel purchase is tied to tender offers, the parent's exposure can be readily limited in time (to a period beginning with the opening or closing of the tender offer), and the parent therefore will not have a potential compulsory purchase continually hanging over its head. Preliminarily, it may be questioned how serious a problem such an overhang would be. As long as the triggering percentage is relatively high, the overhang will relate to an amount of shares which will be relatively small in light of the purchases already made. Furthermore, if this argument were valid, it should also be applicable to the short-form merger statutes, since an overhanging threat to shareholders in a subsidiary would seem as serious as an overhanging threat to the parent.⁴²⁰ But no short-form merger statute limits the period during which the parent's right may be exercised. In any event, even assuming that a time limit on the right to compel purchase is desirable, tying the right to tender offers is not the only way to achieve the objective. The statute could make a time limit run from the date at which the parent achieves the triggering percentage, regardless of the means by which it does so, and require the parent to

420. The two threats are of different import: The threat to the parent is that it will have to pony up cash to purchase minority stock; the threat to minority shareholders of the subsidiary is that they will have to sell their shares on demand at an appraised price, which will probably put a lid on the market price of their shares.

notify remaining shareholders that it has achieved the triggering percentage and that they have a right to compel purchase within the designated period.

A third argument for limiting the right to compel purchase to the tender-offer context is that the persons who really need the right are those who owned stock in the subsidiary prior to the date when the parent achieved the triggering percentage. Those who become shareholders thereafter present a much less sympathetic case for relief, at least if they had knowledge of the parent's dominant position. Tying such relief into tender offers may thus be a crude method of limiting it to persons who owned shares when the parent achieved the triggering percentage. It is not clear how much weight should be given to this argument, because a shareholder might purchase his shares after the acquiring corporation has achieved dominance, but without knowledge of that fact. But if the problem is thought to be serious it can be dealt with by limiting relief to those who were shareholders when the triggering percentage was achieved or became shareholders within a specified period thereafter.

A final question concerning legislation like section 209(2) is how high the triggering percentage should be. The Jenkins Committee rejected a proposal to reduce the triggering percentage in section 209(2) from 90 percent to a bare majority on the ground that it "would have the effect of converting every partial takeover offer into an offer for all the outstanding shares of the class concerned, [and] goes too far."⁴²¹ Obviously, any figure chosen for this purpose will be somewhat arbitrary, but if the figure is set too low it may discourage takeovers, which would probably have a deleterious effect both on the economy as a whole and on shareholders as a class.⁴²² A relatively high figure, even as high as 90 percent, does not seem unreasonable, particularly in the context of an American statute, since the operation of such provisions in this country remains to be tested.⁴²³

(iv) Shareholders of the survivor in stock-for-stock combinations

(A) Under the traditional statutes: a step-transaction theory.—Although a stock-for-stock transaction requires no corporate action by the transferor, it does require corporate action by the survivor, which must issue its own stock and acquire stock of the

421. *Jenkins Committee Report*, *supra* note 414, at 106.

422. *See, e.g., Katz*, *supra* note 45, at 82-83; *Manne, Cash Tender Offers for Shares—A Reply to Chairman Cohen*, *supra* note 174. *See text accompanying notes 173-82 supra.*

423. A special problem which arises in the American context is whether such legislation should be restricted (as the New Jersey provision) to cases where both corporations are

transferor. In many cases such a transaction is followed by a classical merger, a stock-for-assets merger, a liquidation of the transferor, or (if the survivor acquires the requisite percentage of the transferor's stock) a short-form merger.⁴²⁴ These cases raise a special question, and will be examined first.

If a stock-for-stock transaction is followed by a classical merger, the survivor's shareholders will have voting and appraisal rights under the merger statute. The same result should obtain under most statutes if the combination is followed by a stock-for-assets merger. In contrast, a liquidation of, or short-form merger with, the transferor will not in itself give voting or appraisal rights to the survivor's shareholders under the statutes. However, if the liquidation or short-form merger was preplanned, the two steps (stock acquisition and short-form merger or liquidation) should be viewed as an integrated whole for statutory purposes under the step-transaction theory of statutory interpretation formulated by the courts applying

incorporated in the enacting state. Such a limitation would severely cut the efficacy of this type of legislation, since it would be relatively fortuitous that the subject of a takeover bid was incorporated in the same state as the bidder. But the question is then raised, how far could an enacting state go before running up against constitutional limitations on legislative jurisdiction? Probably a state could constitutionally require shareholders of corporations incorporated under its laws to purchase from or sell shares to each other at a fair price under appropriate circumstances, even if the shareholders were not domiciled within it. As applied to the problem at hand, this would mean that a state could constitutionally make legislation like section 209 applicable where the subsidiary is incorporated under its laws even though the parent is not. First, the traditional choice-of-laws rules have given states fairly wide-ranging powers over corporations incorporated under their laws, particularly as regards internal corporate affairs. See RESTATEMENT (SECOND) OF CONFLICTS § 166a and comment *a* at 64-65 (Tent. Draft No. 7, 1962); Reese & Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118, 1124-28 (1958). It may be questioned whether the law of the state of incorporation is the most appropriate law to govern internal affairs of this type. Cf. A. EHRENZWEIG, *A TREATISE ON THE CONFLICT OF LAWS* 411-12 (1962); Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968). That question is beyond the scope of this Article; however, assuming the law of a state other than the state of incorporation (e.g., the state in which the principal place of business is located) is more appropriate, the question at hand would simply be changed to the comparable question, how far may the legislative jurisdiction of *that* state be constitutionally extended? Second, if such legislation could be constitutionally applied only when both corporations were incorporated in the enacting state, really effective legislation along these lines could not be enacted, except perhaps by Congress. Finally, the Supreme Court has indicated in *Clay v. Sun Ins. Office, Ltd.*, 377 U.S. 179 (1963), that state legislation will not be quickly ruled unconstitutional on conflict-of-law grounds. See Note, 26 U. PITT. L. REV. 627, 630-31 (1965).

424. Cf. Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 1028-29 (1957); Comment, *Jurisdiction of the California Corporations Commissioner over Delaware Short Form Mergers*, 52 CALIF. L. REV. 1016 (1964); Note, *The Right of Shareholders Dissenting from Corporate Combinations to Demand Cash Payment for their Shares*, 72 HARV. L. REV. 1132, 1141 (1959).

the federal income tax statutes.⁴²⁵ Since the transaction, as planned, involves the complete fusion of another corporation into the survivor through the issuance of stock by the survivor, it should be treated as a merger of the survivor within the meaning of the traditional corporate statutes. In cases raising comparable problems under the tax laws the courts have reached just such a result under just such a theory.⁴²⁶ This was the result reached by the New Jersey court in *Applestein*, although the step-transaction theory was not there employed.

Suppose, however, that a stock-for-stock transaction is not followed by a merger or liquidation, or at least not by one that is pre-planned? If the survivor acquires 100 percent of the transferor's stock, a strong argument can be made that the transaction constitutes a merger within the contemplation of the statutes, since the two shareholder groups will have been fused, as in a merger, and the transferor's assets will come completely within the survivor's control, as in a merger. Nevertheless, by hypothesis there will not be a complete fusion at the corporate level: The transferor's assets will be segregated from the survivor's assets by a corporate shell and, in theory at least, the survivor will therefore not be legally responsible

425. Cf. *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), cert. denied, 306 U.S. 661 (1939); *Walter S. Heller*, 2 T.C. 371 (1943), aff'd, 147 F.2d 376 (9th Cir. 1945), cert. denied, 325 U.S. 868 (1945). See generally *Mintz & Plumb, Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX. 247 (1954).

426. See *South Bay Corp. v. Commissioner*, 345 F.2d 698, 700-05 (2d Cir. 1965); *Commissioner v. Ashland Refining Co.*, 99 F.2d 588 (6th Cir. 1938); *Kimbell-Diamond Milling Co.*, 14 T.C. 74, aff'd per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827 (1951); *Sapienza, Tax Considerations in Corporate Reorganizations and Mergers*, 60 NW. U.L. REV. 765, 783-84 (1966); *Vesely, "A" Reorganizations—Statutory Mergers and Consolidations*, 19 W. RES. L. REV. 975, 981-84 (1968); cf. *D. HERWITZ, supra* note 375, at 721 n.6; *Hill, The Sale of Controlling Shares, supra* note 424, at 1028-35 (problems arising out of the acquisition of control shares as a step in the acquisition of corporate assets); *Jennings, Trading in Corporate Control, supra* note 63, at 22-29 (same). But cf. *Orzeck v. Englehart*, 41 Del. Ch. 361, 366-67, 195 A.2d 375, 378 (1963) (dicta).

The step transaction theory could also be applied to justify the result reached by the courts in *Rath* and *Farris*. On the other hand, the theory normally need not be applied in favor of the transferor's shareholders in a stock-for-stock combination. (1) If such a combination is followed by a classical merger, the nontransferring shareholders will have both voting and appraisal rights by virtue of the statute. (2) If such a combination is followed by a stock-for-assets merger, the same result should also obtain. (3) If such a combination is followed by a short-form merger, the transferor's nontransferring shareholders (unlike the survivor's shareholders) will have appraisal rights by virtue of the short-form merger statute. They will not have voting rights, but that is academic, because even if they had such rights, and voted against the transaction, it would nevertheless pass by virtue of the survivor's overwhelming stock ownership in the transferor. (4) If such a combination is followed by liquidation of the transferor, the nontransferring shareholders will have voting rights by virtue of the dissolution statutes. They will not have appraisal rights; but the liquidation will take them out of the enterprise. In any event, liquidation is unlikely where nontransferring shareholders remain because in the event of liquidation such shareholders would be entitled to a portion of the transferor's assets. See

for the transferor's liabilities. So in *Cummings v. United Artists Theatre Circuit, Incorporated*,⁴²⁷ United Artists, which had owned 50 percent of the stock of United California, acquired the remaining 50 percent from United California's shareholders in exchange for United Artists stock. A United Artists shareholder challenged the transaction by arguing, among other things, that the combination was a merger effected without the requisite shareholder approval. The court rejected this argument, and distinguished *Applestein* on the ground that the plaintiff had not proved the existence of a plan to merge the two corporations.⁴²⁸

(B) *Under common law principles.*—But granted that a stock-for-stock transaction is not a merger within the meaning of the traditional statutes unless followed by a preplanned merger or liquidation, that is not the end of the inquiry. Such a transaction may then be viewed as a purchase of the transferor's stock or an issuance of the survivor's stock. If it is viewed as a purchase of the transferor's stock, the relevant statutory provision is the common provision enabling a corporation to acquire stock.⁴²⁹ Such provisions, however, only create a corporate power; they do not normally specify what body within the corporation is to exercise that power. It is sometimes assumed that the board can exercise all corporate powers, except insofar as the statutes otherwise provide, but that assumption is not warranted,⁴³⁰ and whether a transaction is a board or a shareholder matter, when the statute is silent, should depend on common law principles as informed by the normative models. These principles would indicate that a stock-for-stock combination should require approval by the survivor's shareholders when the proportionate amount of stock issued by the survivor is significant, for the same reasons that a classical or stock-for-assets merger should require such approval—such a transaction effects a significant restructuring of the enterprise and reallocation of the underlying ownership interests, and is mechanically appropriate for shareholder action.⁴³¹

Kellogg v. Georgia-Pacific Paper Corp., 227 F. Supp. 719 (W.D. Ark. 1964); Zimmerman v. Tide Water Associated Oil Co., 61 Cal. App. 2d 585, 143 P.2d 409 (1943); *In re San Joaquin Light and Power Corp.*, 52 Cal. App. 2d 814, 127 P.2d 29 (1942).

427. 237 Md. 1, 204 A.2d 795 (1964).

428. *Id.* at 23-24, 204 A.2d at 806-07 (1964).

429. See CAL. CORP. CODE § 802(d) (West 1955); DEL. CODE ANN. tit. 8, § 123 (1967); ILL. ANN. STAT. ch. 32, § 157.5(g) (Smith-Hurd 1954); N.J. STAT. ANN. § 14A:3-1(f) (Supp. 1968); N.Y. BUS. CORP. LAW § 202(a)(6) (McKinney 1963); OHIO REV. CODE ANN. tit. 17, § 1701.13 (F)(3), (G) (Page 1964); MODEL BUS. CORP. ACT ANN. § 4(g) (1960).

430. See text accompanying note 268-82 *supra*.

431. See text accompanying note 368-69 *supra*.

Suppose, however, that a stock-for-stock combination is viewed as an issuance of stock by the survivor. The relevant statutory provisions are then the provisions governing the issuance of stock. These provisions commonly take one of two forms—some merely empower the board to fix the consideration for which stock is issued,⁴³² but others specifically empower the board to issue stock.⁴³³ Under the latter type of provision, at least, requiring shareholder approval may not seem easy to reconcile with the statute. Nevertheless, a case for requiring shareholder approval by the survivor's shareholders can still be made.

(C) A theory of proprietary limits on statutory board powers.—Corporate law has traditionally distinguished powers from purposes. It is well established that corporate powers can be exercised only to achieve legitimate (law-and-charter-approved) corporate purposes. It is also well established that board powers can be exercised only to achieve legitimate board purposes. Thus, despite the issuance-of-stock provisions just cited, the board may not fix the consideration for which stock is issued at a price which is unfairly low in relation to the interests of existing shareholders,⁴³⁴ nor may the board issue stock for the purpose of reallocating control.⁴³⁵

These restrictions are usually considered to be two instances of a general class of limitations on the statutory powers of the board known as equitable limitations—limitations derived from the general theory that corporate powers are held in trust, and must be used fairly by those who exercise them, notwithstanding apparently unrestricted statutory language.⁴³⁶ But powers conferred on the board may also be deemed subject to another class of limitations: that they may be used only to achieve purposes related to the management of the corporation's business—that is, used only to effectuate decisions of

432. See statutes cited in note 293 *supra*.

433. See statutes cited in note 292 *supra*.

434. Note, *Judicial Control over the Fairness of the Issue Price of New Stock*, 71 HARV. L. REV. 1133 (1958).

435. *Kullgren v. Navy Gas & Supply Co.*, 110 Colo. 454, 135 P.2d 1007 (1943); *Condec Corp. v. Lunkenheimer Corp.*, 230 A.2d 769 (Del. Ch. 1967); *Rowland v. Times Publishing Co.*, 160 Fla. 465, 35 So. 2d 399 (1948); *Trask v. Chase*, 107 Me. 137, 77 A. 698 (1910); *Andersen v. Albert & J. M. Andersen Mfg. Co.*, 325 Mass. 343, 90 N.E.2d 541 (1950); *Glenn v. Kitanning Brewing Co.*, 259 Pa. 510, 103 A. 340 (1918); *cf. Browning v. C & C Plywood Corp.*, 434 P.2d 339 (Ore. 1967).

436. See SEC, PROTECTIVE COMMITTEE REPORT, Part VII, *supra* note 65, at 519; Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Lattin, *Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders*, 30 MICH. L. REV. 645 (1932); *cf. Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942); *In re Security Finance Co.*, 49 Cal. 2d 870, 317 P.2d 1 (1957).

the kind we have labeled business (*e.g.*, issuing stock to increase working capital), rather than the kind we have labeled structural. This class of limitations may be referred to as proprietorial limitations, since they derive from the theory that the board's function is to manage the corporation's business, while decisions relating to the general structure of the enterprise are matters for the proprietors of the enterprise—shareholders.

Such limitations have been recognized by unofficial sources of corporate law. Thus the New York Stock Exchange addresses its listed companies as follows in its *Company Manual*:

Good business practice is frequently the controlling factor in the determination of management to submit a matter to stockholders for approval even though neither the law nor the company's charter makes such approval necessary.⁴³⁷

The Exchange backs up this general exhortation by concrete sanction-backed directives, several of which relate directly to the issuance of stock; as we have already seen, both the New York and American exchanges require approval of a stock-for-stock combination by the survivor's shareholders where the amount of stock issued or issuable by the survivor represents 20 percent or more of its outstanding common.⁴³⁸ Similarly, the National Industrial Conference Board reports that:

Three fifths of the companies in a 1958 survey on the subject have approached stockholders on problems though the directorate was authorized to handle them.⁴³⁹

A number of reasons were ascribed for such submissions:

One [reason] is described by an executive of an industrial machinery company: "Where there has been doubt under state law, our counsel resolves problems in favor of seeking stockholder approval and our board has agreed with the counsel's advice." And according to the vice-president of a chemicals firm "there is often the moral obligation to secure stockholders' approval as well as legal necessity." In other instances, boards follow the policy of putting their major decisions before the stockholders so as to obtain their backing.⁴⁴⁰

437. NEW YORK STOCK EXCHANGE, COMPANY MANUAL at A-283 (1968).

438. See text accompanying note 399 *supra*.

439. J. BACON, CORPORATE DIRECTORSHIP PRACTICE 102 [N.I.C.B. Studies in Business Policy No. 125 (1967)].

440. *Id.* at 102-03.

More conventional legal authorities have also recognized such limitations. Thus, while the power to manage carries with it the power to delegate, the delegation may not be so extensive and for so long a period of time that it negates the power of the shareholders to elect new management periodically.⁴⁴¹ The cases holding that the board may not issue stock for the purpose of reallocating control, which are normally read as reflecting a principle of equitable limitations on the power of the board, may also be read as reflecting a theory of proprietary limitations on the board's powers.

Similarly, many statutes provide that the board, if authorized to do so by the certificate, can divide any class of preferred stock into "series," and fix the terms of each series, within certain limits, without shareholder approval.⁴⁴² Some of these statutes restrict the kinds of terms which the board can set⁴⁴³ and explicitly prohibit the board from conferring intraclass preferences—that is, from preferring one series over another as to dividends or liquidating distributions.⁴⁴⁴ However, other statutes are much broader. For example, California permits the board to fix "dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions); the redemption price or prices, [or] the liquidation preferences"⁴⁴⁵ But it has been said that

[d]espite the generality of the language, the author does not believe that this amendment should be construed as authorizing the directors to give one series a priority over another as to dividends. . . . [I]t does not appear proper to allow the directors to alter fundamentally the stock structure and classification in this way without stockholder approval, particularly if a new series might thus obtain priority over outstanding shares of the same class.⁴⁴⁶

441. See *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930); cf. *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945).

442. See generally Berle, *Corporate Devices for Diluting Stock Participations*, 31 COLUM. L. REV. 1239, 1263-64 (1931); Berle, *Investors and the Revised Delaware Corporation Act*, 29 COLUM. L. REV. 563, 565-67 (1929); Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 247-49 (1954).

443. ILL. ANN. STAT. ch. 32, § 157.15 (Smith-Hurd 1954); OHIO REV. CODE ANN. tit. 17, § 1701.06(A)(12) (Page 1964); PA. STAT. ANN. tit. 15, §§ 1602(A), (B) (1967); ABA MODEL BUS. CORP. ACT ANN. § 15 (1960).

444. See I CHICAGO BAR ASS'N, ILLINOIS BUSINESS CORPORATION ACT ANNOTATED WITH FORMS 93 (2d ed. 1947).

445. CAL. CORP. CODE § 304 (West 1955).

446. Loomis, *Corporations Code Amendments*, 23 S. CAL. L. REV. 12, 13-14 (1949); cf. H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS 77 (4th ed. 1967). But cf. Buxbaum, *supra* note 442, at 248. See also Berle, *Corporate Devices for Diluting Stock Participations*, *supra* note 442, at 248.

Applying this theory of proprietary limitations to the problem at hand, the board's power to fix consideration for the corporation's stock, or to issue stock, should not be used to accomplish a purpose—the restructuring of the enterprise and reallocation of ownership interests through a corporate combination—which is properly a shareholder matter under common law principles, as informed by the normative models. Therefore, even if a stock-for-stock combination is viewed as an issuance of stock by the survivor, where the amount of stock issued is proportionately significant the combination should require approval by the survivor's shareholders.

A theory of proprietary limitations would, of course, have other applications. For example, although the short-form merger statutes, which permit the board to effect certain mergers without shareholder approval, are normally made explicitly inapplicable to any merger which works a change in the parent's certificate, the Delaware and New York statutes are not completely clear on this issue.⁴⁴⁷ A theory of proprietary limitations would prohibit the board from effecting a material change in the parent's certificate through a short-form merger, notwithstanding the apparent breadth of its powers under these statutes.

(D) *A revised de facto theory.*—Up to now, we have not inquired directly into the validity of the de facto merger theory, since the use of such a theory has not been necessary for the solution of any of the problems we have so far encountered. However, granted that a stock-for-stock combination is not a merger within the meaning of the statutes—a de jure merger—the question arises whether it is nevertheless a de facto merger.

Preliminarily, it is necessary to formulate a general de facto theory, which is not to be found in the cases employing the term, except by inference. We might begin with a formulation made by Professor Lattin around the time *Farris* was decided, but without special reference to that case: “One authorized device may not be used to accomplish a result within the purview of another authorized device.”⁴⁴⁸ This formulation (which seems implicit in *Farris*, *Applestein*, and, to a lesser extent, *Rath*), provides an important first step. However, the theory as so formulated cannot easily withstand the Delaware equal-dignity theory, formulated as a counter to it, that the validity of “action taken under one section of . . . law is not

447. See note 231 *supra*.

448. Lattin, *Minority and Dissenting Shareholders' Rights in Fundamental Changes*, *supra* note 314, at 313.

dependent upon, nor to be tested by the requirements of other unrelated sections.⁴⁴⁹ For surely there are cases where a legislature intentionally drafts a statute to permit the same result to be reached by more than one route, and in such cases one may elect which route to use. On the other hand, surely it will sometimes happen that although two provisions appear to furnish alternative routes to the same end, the legislature did not intend that both could be so utilized. The problem is to formulate standards by which the two cases can be distinguished. One index is whether a purpose of one of the provisions is the protection of a certain class of persons in connection with the achievement of a given result. If the other provision does not have comparable protections, one should be wary of construing it to permit an equivalent result, unless the legislature has made clear that it intends such an anomaly.

The de facto theory may therefore be reformulated as follows: If a purpose of a statutory provision is the protection of a certain class of persons in connection with the achievement of a given result, a statutory provision which appears to enable an equivalent result to be achieved without comparable protections should not be so construed unless it is clear that the provision was so intended.

Applying this reformulated theory to stock-for-stock transactions from the survivor's perspective:

(1) One purpose of the merger provisions is the protection of certain classes of persons (shareholders as a body and minority shareholders). The issuance of stock provisions contain no comparable protection.

(2) Does a stock-for-stock combination achieve a result equivalent to a merger? Like a merger, such a combination involves a reallocation of ownership among the shareholders of two previously separate corporations, and the effective combination of two asset groups previously under separate corporate control. The major, indeed the only significant difference between a stock-for-stock combination and a merger is that in the former the two legal shells are not fused and (therefore) the survivor does not become legally responsible for the transferor's liabilities. This difference is likely to be inconsequential as a practical matter, because the survivor may become liable under a piercing-the-veil theory, or may choose to pay the transferor's liabilities even if not legally required to do so, because of a supposed or moral obligation, or to attain or retain goodwill, or to forestall placement of the transferor's assets on the sheriff's

449. See text accompanying notes 303-06 *supra*.

auction block.⁴⁵⁰ In all economic essentials then, a stock-for-stock combination achieves a result equivalent to a merger.

(3) Did the legislature nevertheless intend to permit stock-for-stock combinations to be achieved under the issuance-of-stock provisions? There is certainly nothing to so indicate; these provisions can be given ample scope even if they are not construed to include such combinations. Under de facto theory, therefore, stock-for-stock combinations should either be treated under common-law principles or analogized to classical mergers under the statute and given equivalent treatment. Which route is followed may make a substantial difference. Common law principles would only require shareholder approval, while the merger statutes would usually provide for appraisal rights and require the approval by two-thirds of the outstanding shares.

(E) *A statutory solution.*—A statutory solution of the stock-for-stock combination problem, based on the significance of the transaction to the survivor and generally following the lines laid down for a solution to the stock-for-assets problem, would clearly be desirable. Ohio has adopted such a solution, the thrust of which is that such combinations require approval by, and trigger appraisal rights in, the survivor's shareholders, if the survivor issues stock carrying one-sixth of its voting power in exchange for stock in the transferor carrying the majority of the transferor's voting power.⁴⁵¹ Such a solution (which is comparable to Ohio's solution of the stock-for-assets problem) is sound in principle. However, because of considerations examined in connection with Ohio's stock-for-assets provision, it would be preferable to make the test for voting and appraisal rights turn on the amount of common stock issued or issuable by the survivor, rather than on the number of votes carried by either the issued or the acquired shares.

2. *The Cash Modes*

As noted at the outset of this Part, there are also two cash modes of combination—cash-for-assets, in which the survivor acquires substantially all of the transferor's assets for cash, and cash-for-stock, in which the survivor acquires a controlling amount of the transferor's

450. Cf. *Heimann v. American Express Co.*, 53 Misc. 2d 749, 279 N.Y.S.2d 867 (Sup. Ct. 1967).

451. OHIO REV. CODE ANN. tit. 17, §§ 1701.01(R), (S), 1701.84(A), (D) (Page 1964). The voting power is measured by voting rights in the election of directors "immediately after the consummation of [the] transaction."

stock for cash. The cash modes resemble classical mergers and the stock modes in that the assets, and frequently the management, of the two constituents are combined. They differ in that the shareholder groups and corporate entities are not. Because of this, the cash modes are pretty clearly not de jure mergers; nor are they de facto mergers, since the results reached are not economically equivalent to de jure mergers. Whether such transactions should require shareholder approval or trigger appraisal rights is therefore a matter of common law principles or statutory reform. Most of the law and principles applicable to the cash modes have already been developed in connection with the stock modes, and this section will therefore be confined to a summary discussion.

(a) Cash-for-assets combinations from the transferor's perspective.—Where substantially all of a corporation's assets are sold for cash, the transaction constitutes a radical reconstruction of the enterprise from the transferor's perspective, and approval by the transferor's shareholders should be required, just as it should be if substantially all assets are exchanged for stock. There is, however, an important difference between a stock-for-assets and a cash-for-assets transaction; where the transfer is for stock the result is not only a radically restructured but a continuing enterprise, and appraisal rights are therefore in order. However, where the transfer is for cash, and as part of the plan the transferor is liquidated and the cash distributed (as is typically the case), the transferor's shareholders are not being brought along in a continuing enterprise, and appraisal rights are therefore inappropriate.⁴⁵²

452. Cf. N.Y. BUS. CORP. LAW § 910(a)(i)(B) (McKinney 1963); ABA MODEL BUS. CORP. ACT ANN. § 73(b) (1960); Folk, *Corporation Statutes: 1959-1966*, *supra* note 398, at 945-46.

The 1959 amendments to the Pennsylvania statute, discussed in the text accompanying notes 375-85, *supra*, apparently deal only with stock-for-assets, not with stock-for-stock transactions. It might, however, be argued that they are also applicable to stock-for-stock transactions, by negative implication. Such an argument would seem unsound, for reasons parallel to those discussed in the text accompanying notes 381-85 *supra*, as to the applicability of the amendments to voting rights. There is, however, one additional factor relevant to this problem. The amendment to the sale-of-substantially-all-assets provision is applicable where a corporation "acquires by purchase . . . all or substantially all of the *property* of another corporation." (Emphasis added.) This clearly does not include a stock acquisition, since stock is the property of the shareholder, not of the other corporation. However, the amendment to the merger section provides that "Where a corporation acquires *assets* by purchase . . . the rights if any of dissenting shareholders shall be governed by" the sale-of-substantially-all-assets provision. (Emphasis added.) It is arguable that this section does include a stock acquisition, since stock is an "asset." See D. HERWITZ, *supra* note 375, at 54. But in the context of the cross-

(b) *Cash-for-stock combinations from the transferor's perspective.*—We have already seen that a stock-for-stock combination should not require approval by the transferor's shareholders, but if the acquiring corporation achieves a dominant position, nontransferring shareholders should have a right to compel purchase of their stock. The reasons behind those conclusions would seem equally applicable to cash-for-stock combinations.

(c) *Cash-for-assets combinations from the survivor's perspective.*—If the amount of cash paid by the survivor in a cash-for-assets transaction is not material in relation to the survivor's total assets, the transaction should not require approval of the survivor's shareholders, any more than should a small-scale stock-for-assets transaction. Suppose, however, that a material amount of cash is involved. This presents an extremely difficult problem.⁴⁵³ Such a transaction will by hypothesis effect a change in the nature of a significant amount of the transferor's assets. However, unlike a stock acquisition, which involves an increase in the size of the enterprise and a material reallocation of ownership interests, a cash transaction may involve neither an increase in the size of the survivor's assets (but instead only a reshuffling of liquid into fixed assets), nor a reallocation of ownership interests. Furthermore, since no reallocation of ownership interests is involved, a cash transaction is less likely to result in a fusion of top management than a stock transaction. Given all these factors, cash transactions will frequently be difficult to distinguish from internal expansion along existing lines; that is, they will frequently not rise to the level of a structural change. Therefore, shareholder approval should not normally be required for such a transaction, except perhaps where the amount of cash paid out represents a very substantial portion of the survivor's total assets.

However, one type of cash transaction may need special treatment. Assume that, as for example under the Ohio statute, shareholder approval would be required, and appraisal rights triggered, by a stock-for-assets transaction, but not by a comparable cash-for-assets transaction. Now suppose a corporation issues stock for cash, and then, in a preplanned transaction, uses the cash to acquire substantially all of another corporation's assets. What result?

reference to the sale-of-substantially-all-assets section and the traditional distinction between asset and stock transactions, it seems fairly clear that the term "assets" as used in the amendment to the merger section is meant to apply only to acquisitions of corporate assets, and not to acquisitions of corporate stock.

453. See D. HERWITZ, *supra* note 375, at 723.

It has been argued that the statute would be inapplicable "even though the net effect of these two transactions upon the stockholders of the acquiring corporation would be exactly the same as if the assets had been acquired directly in exchange for the stock" ⁴⁵⁴ But this seems incorrect. If the use of the proceeds was preplanned, such a transaction can and should be handled by application of the step-transaction theory.

(d) Cash-for-stock combinations from the survivor's perspective.— From the perspective of the survivor's shareholders a cash-for-stock combination is virtually identical to a cash-for-assets combination, and the same conclusions follow.

C. Corporate Divisions

In a corporate combination, two corporations are effectively fused by the transfer to one of substantially all of the assets of (or a controlling stock interest in) the other. A second major category of transactions, which may be called corporate divisions, involves the transfer of a business comprised of a significant portion, but less than substantially all, of a corporation's assets. (Such a business will be referred to hereafter as a "significant business.") Although such transactions are extremely common and are frequently of great significance to the enterprise, typically they are not explicitly covered by the corporate statutes. In this section we shall examine some of the major categories of such transactions and analyze them under statutory and common law principles.

1. Sell-Offs

One important class of corporate divisions consists of transfers of a significant business to a corporation which is not a subsidiary of the transferor, in exchange for cash or debt instruments. In this section we will examine the case where the proceeds of the disposition are not distributed directly to the shareholders. These transactions are frequently referred to as "sell-offs."⁴⁵⁵ The reasons for them are enormously varied: Perhaps the business is a loser which the transferee thinks can be turned into a winner; perhaps the transferor needs to sell off one business to raise working capital for others; or perhaps the disposition is required by an antitrust divestiture decree.⁴⁵⁶

454. *Id.* See also Folk, *Corporation Statutes: 1959-1966*, *supra* note 398, at 945.

455. See, e.g., *Corporate Sell-Off*, MERGERS & ACQUISITIONS, March-April 1968, at 74; May-June 1968, at 84; July-August 1968, at 82.

456. *Id.* The listed reasons for sell-offs are of course not exclusive.

(a) *Under the traditional corporate statutes.*—In analyzing whether such transactions require shareholder approval and trigger appraisal rights, we must again begin with the statutes, and in particular the provisions governing a “sale . . . of all or substantially all the assets of a corporation.” We have already seen one serious ambiguity in this language—the meaning of the term “sale.”⁴⁵⁷ We shall now explore another—the meaning of the term “assets.”

(i) *Where the retained assets do not include a significant business.*—Assume first that the transferor retains a significant amount of liquid assets (such as cash, accounts receivable, marketable securities held for investment, or the like), but does not retain another significant business, so that the transfer involves less than substantially all of the transferor’s total assets, but substantially all of its operating assets. Are the sale-of-substantially-all-assets provisions applicable? This raises the question whether the measurement of “substantially all . . . assets” is strictly quantitative, based solely on the proportion between the value of the assets conveyed and the value of the assets retained, or also has a qualitative aspect, taking into account the nature of the assets conveyed and retained. To put this in statutory terms, does the term “assets” as used in these provisions mean “total assets” or “operating assets?”

This question has been but seldom confronted by the corporate-law cases. Most of the small number of cases in which the issue has been squarely raised have either been relatively simple—involving, for example, the disposition of more than 95 percent⁴⁵⁸ or less than five percent⁴⁵⁹ of the transferor’s total assets—or have not made explicit the nature and amount of assets involved.⁴⁶⁰ The background of the statutes, however, sheds some light on the problem. It is generally accepted that at common law a sale of substantially all assets required unanimous shareholder approval on the theory that it breached an implied contract between the shareholders to further the corporate enterprise, and that the purpose of the sale-of-substantially-all-asset provisions was to modify the rigor of this rule by reducing the required shareholder approval from unanimity to two-thirds or a

⁴⁵⁷ See text accompanying notes 352-55 *supra*.

⁴⁵⁸ See *Prince George’s Country Club, Inc. v. Edward R. Carr, Inc.*, 235 Md. 591, 202 A.2d 354 (1964).

⁴⁵⁹ See *Klopot v. Northrup*, 131 Conn. 14, 37 A.2d 700 (1944).

⁴⁶⁰ See *Frankel v. Tremont Norman Motors Corp.*, 21 Misc. 2d 20, 193 N.Y.S.2d 722 (Sup. Ct. 1959), *aff’d*, 10 App. Div. 2d 680, 197 N.Y.S.2d 576 (1960), *aff’d*, 8 N.Y.2d 901, 168 N.E.2d 823, 204 N.Y.S.2d 146 (1960).

majority.⁴⁶¹ In other words, the provisions were directed at transfers which effectively put a corporation out of the business in which it was engaged. The term "substantially all . . . assets" should be therefore interpreted to mean operating assets essential to the conduct of the enterprise as a going concern. Thus the statutes should be applicable if substantially all operating assets are disposed of, notwithstanding the retention of a large amount of liquid assets, unless perhaps the operating assets are themselves not significant.

The few cases that have explicitly dealt with transactions in the grey area tend to support this conclusion. Thus in *Stiles v. Aluminum Products Company*,⁴⁶² the corporation sold all of its operating assets but retained liquid (and a small amount of non liquid) assets amounting to 35 percent of total assets. The court held that the transaction constituted a sale of "substantially all" of the corporation's assets within the meaning of the Illinois statute. In *Ostlind v. Ostlind Valve, Incorporated*,⁴⁶³ the corporation's assets consisted of approximately 55,000 dollars in cash and a one-fourth interest in certain patents. The corporation wished to have the patents sold for 100,000 dollars plus royalties. The plaintiff, a minority shareholder, brought an action in which he objected, among other things, to the use of corporate funds (rather than a broker working on commission) to promote this sale. The court rejected this position, but noted that

The powers of directors are not unlimited but extend only to the ordinary or regular business of the corporation. . . . The sale of the corporation's last remaining asset, other than its cash, would not be, of course, the transaction of its ordinary business. . . . It need hardly be added that the sale . . . will not be valid unless made with the consent of two-thirds of the issued capital stock [under the relevant sale-of-substantially-all-assets provision.]⁴⁶⁴

461. See, e.g., Note, *Interplay of Rights of Stockholders Dissenting from Sale of Corporate Assets*, 58 COLUM. L. REV. 251, 252-53 (1958); Note, *Dispositions of Corporate Assets*, 43 N.C.L. REV. 957, 958-59 (1965).

462. 338 Ill. App. 48, 86 N.E.2d 887 (1949); cf. *Philadelphia Nat'l Bank v. B.S.F. Co.*, 41 Del. Ch. 509, 199 A.2d 557 (Ch. 1964), *rev'd on other grounds*, 204 A.2d 746 (Sup. Ct. 1964).

463. 178 Ore. 161, 165 P.2d 779 (1946).

464. *Id.* at 191-92, 165 P.2d at 791. In *Krell v. Krell Piano Co.*, 23 Ohio N.P. (n.s.) 193 (Sup. Ct. 1920), *aff'd on other grounds*, 14 Ohio App. 74, *motion to certify record denied*, 14 Ohio App. xxxviii (1921), a lower court held that a transfer of a corporation's entire operating assets for \$155,000 worth of preferred stock was not a sale of the "entire property and assets" of the corporation within the meaning of the statute because non-operating assets (in excess of \$200,000) were retained. An appellate court assumed, without deciding, that the transaction did constitute the sale of the corporation's entire property and assets, but upheld the lower court's decision on other grounds.

Finally, several cases have indicated in dicta that the applicability of substantially-all-assets provisions turns on such tests as whether the transaction "tends to interfere with the integrity of the corporation and to impair its capacity to perform its functions as a going concern,"⁴⁶⁵ or involves "a part [of the assets] essential to the continuance of the corporate enterprise."⁴⁶⁶

Similar results have been reached, in a different context, under the reorganization provisions of the Internal Revenue Code. Thus section 368(a)(1)(C) of the Code provides that a stock-for-assets transaction can qualify as a reorganization if it involves "substantially all of the properties" of the transferor. In *Revenue Ruling* 57-518, the Commissioner ruled that in applying this provision "what constitutes 'substantially all of the properties' . . . will depend upon the facts and circumstances in each case rather than upon any particular percentage. Among the elements of importance that are to be considered in arriving at the conclusion are the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof."⁴⁶⁷ In *James Armour, Incorporated*,⁴⁶⁸ the tax court held that a comparable requirement in section 354(b)(1) was satisfied where "as a result of the transactions [the transferee] either acquired title to, or the use of, all the assets essential to the conduct of [the transferor's] business enterprise," although only 51 percent of the transferor's total assets had been conveyed.

In short, shareholder approval should normally be required under

In two early California cases it was held that a sale of *all* of a corporation's tangible assets did not fall within a statutory provision requiring two-thirds shareholder approval for any "sale . . . of the business, franchise and property, as a whole," on the theory that the corporation had not sold its right to do business. *Shaw v. Hollister Land & Improvement Co.*, 166 Cal. 257, 135 P. 965 (1913); *Baldwin v. American Trading Co.*, 76 Cal. App. 80, 243 P. 710 (1923); *cf. Painter v. Brainard-Cedar Realty Co.*, 29 Ohio App. 123, 163 N.E. 57 (1928). It seems unlikely that a modern court would so reason, *see Note, Sale of Assets: Dissenting Shareholders' Appraisal Right in Absence of Appraisal Statute*, 46 CALIF. L. REV. 283, 286-87 n.23 (1958), unless the corporation showed that it did in fact remain in business. *Cf. Good v. Lackawanna Leather Co.*, 96 N.J. Super. 439, 233 A.2d 201 (Ch. 1967). The California statute now refers to sales of "substantially all . . . property and assets," CAL. CORP. CODE § 3901 (West 1955).

465. *Santa Fe Hills Golf & Country Club v. Safahi Realty Co.*, 349 S.W.2d 27, 36 (Mo. 1961).

466. *Fontaine v. Brown County Motors Co.*, 251 Wis. 433, 438, 29 N.W.2d 744, 747 (1947). For comparable formulations of the common law rule, *see In re De Camp Glass Casket Co.*, 272 F. 558, 564 (6th Cir.), *cert. denied*, 256 U.S. 703 (1921); *Rollins v. Clay*, 33 Me. 132, 139 (1851); *In re Timmis*, 200 N.Y. 177, 181, 93 N.E. 522, 523 (1910); *Abbot v. American Hard Rubber Co.*, 33 Barb. 578 (N.Y. Sup. Ct. 1861); *cf. Siegel, When Corporations Divide: A Statutory and Financial Analysis*, 79 HARV. L. REV. 534, 541 (1966).

467. 1957-2 CUM. BULL. 253, 254; *cf. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, 1233. See also B. BITTKER & J. EUSTICE, supra note 329, at 525-26.*

468. 43 T.C. 295, 309 (1964).

the sale-of-substantially-all-assets provisions when a corporation sells substantially all of its operating assets, even though it does not sell substantially all of its total assets.

(ii) *Where the retained assets do include a significant business.*—Now suppose that the transferor has two or more significant businesses, and sells only one. Should the sale-of-substantially-all-assets provisions still be applicable? It can be argued that the answer is yes. In today's world multi-business corporations are common: for example, a recent analysis of the 500 largest industrial corporations showed that only 102 were operating in a single business category, while 235 were operating in four or more categories and 46 were operating in eight or more.⁴⁶⁹ In many such corporations the businesses are completely unrelated.⁴⁷⁰ But when the statutes were enacted, single-purpose corporations were dominant.⁴⁷¹ If a corporation sold one business it would normally have sold substantially all of its operating assets. It can therefore be argued that the original legislative intent was to require shareholder approval for the sale of *any* significant business. However, such an argument is hard to fit within the statutory language. Even assuming that the term "assets" refers primarily to operating assets, if a significant amount of operating assets are retained it would not seem that "substantially all the assets" have been conveyed.

But saying that the sale-of-substantially-all-assets provisions do not require shareholder approval is not the same thing as saying that shareholder approval is not required, unless those provisions render shareholder approval unnecessary by negative implication. To see whether they do, the provisions must again be set in their historical context. There are two very different legal reasons for requiring shareholder approval for any given transaction: (1) because the transaction is impermissible under the certificate of incorporation, or (2) because, while it is permissible under the certificate or under law, the permission is conditioned on shareholder approval. A transaction which falls into the former category normally requires unanimous shareholder approval, on the theory that a certificate is a contract between the shareholders and that (absent a reserved-power clause) such contracts can be amended only by unanimous consent of the

469. O'Hanlon, *The Odd News about Conglomerates*, FORTUNE, June 1967, at 175. This analysis employed fifty-four categories, based on, but modified from those employed in the U.S. Budget Bureau's *Standard Industrial Classification Manual*.

470. See, e.g., Burck, *The Perils of the Multi-Market Corporation*, FORTUNE, February 1967, at 130.

471. See text accompanying note 251 *supra*.

parties. A transaction which falls into the second category normally requires only majority approval (unless the law or certificate requires a stated high majority), on the theory that corporate bodies normally act by majority vote where acting within their powers. Today there are few transactions that effectively require unanimous shareholder approval, because modern certificates of incorporation are extremely broad and freely amendable. But when the sale-of-substantially-all-assets provisions were enacted, questions about the permissibility of a transaction under the certificate were not uncommon⁴⁷² and, as we have seen, a sale of substantially all assets required unanimous shareholder approval just because it was regarded as a breach of an implied term of the certificate. It was this rule which the sale-of-substantially-all-assets provisions were enacted to alleviate.⁴⁷³ There is nothing to indicate that these provisions were meant to dispense with shareholder approval which was otherwise required by the certificate or by law.⁴⁷⁴ As was said in *Fontaine v. Brown County Motors Corporation*,

The purpose of [the Wisconsin sale-of-substantially-all-assets provision] was to change the common law rule. . . . The subsection applies only to those conveyances for which unanimous consent was required at the common law. To the extent that corporate conveyances at the common law did not require unanimous consent, the statute is inapplicable and the common law remains in effect.⁴⁷⁵

The sale-of-substantially-all-assets provisions therefore do not render

472. Cf. Dodd, *Dissenting Stockholders and Amendments to Corporate Charters*, 75 U. PA. L. REV. 585, 586-92 (1927); McNulty, *supra* note 25, at 27-31.

473. See text accompanying note 461 *supra*. Thus many cases have held that where a sale of substantially all assets is in the ordinary course of business it does not require shareholder approval, despite the fact that the relevant sale-of-substantially-all-assets provision is literally applicable, on the theory that these provisions were not intended to affect such sales because at common law they did not require unanimous shareholder approval. See Note, *Dispositions of Corporate Assets*, *supra* note 461, at 960. A related problem is whether the statutory provisions are applicable when the corporation is insolvent or in failing circumstances. Although unanimous shareholder approval was not required at common law under such circumstances, it is not clear whether the need for shareholder approval was dispensed with entirely, and the courts have split on whether the statutory provisions are applicable. See Comment, *Sale of All or Substantially All of Corporate Assets—Effect of Modern Statutes*, 45 MICH. L. REV. 341 (1947).

474. SEC PROTECTIVE COMMITTEE REPORT pt. VII, *supra* note 65, at 576. The silence of most statutes on the treatment of sales of less than substantially all assets is brought into sharp focus by the Connecticut statute, which explicitly deals with such transactions, albeit unwisely: "[A]ny sale of less than substantially all assets . . . may be made upon such terms and conditions and for such consideration as may be authorized by [the] board of directors." CONN. GEN. STAT. ANN. tit. 33, § 33-372(c) (Supp. 1968).

475. 251 Wis. 433, 437, 29 N.W.2d 744, 747 (1947)

shareholder approval unnecessary by negative implication, if such approval is otherwise required by law.⁴⁷⁶

(b) *Under common law principles.*—We are then left with the question whether shareholder approval should be required under common law principles. The considerations involved are similar to those involved in cash acquisitions. Like a cash acquisition, a sell-off does not alter the total amount of assets under the corporation's control. Such a transaction may therefore be viewed as merely a contraction of operations—a reshuffling, perhaps temporary, of the form in which the corporation's assets are held.⁴⁷⁷ On the other hand, a cash acquisition may closely resemble internal expansion, which is a natural course for any business enterprise. A deliberate contraction of the nature and scale of operations is much less usual, and a subject which the shareholders would be much more likely to want to pass upon. Furthermore, a sell-off normally involves investment, rather than purely business skills—an evaluation of whether the business in question is worth the offering price; is likely to take a relatively long time to effectuate in any event, because of the necessity of investigation, negotiation, drafting of papers, and securing of necessary consents and permits; and is likely to occur only infrequently in the history of a corporation. The sale of a significant business should therefore require shareholder approval.

This presents a problem in planning because of the potential uncertainty in determining whether a business is significant. However, New York for many years (until the enactment of its 1961 Business Corporation Law) required shareholder approval for the sale of assets constituting an "integral part [of the property of the corporation] essential to the conduct of the business of the corporation,"⁴⁷⁸ and New York survived—as one of the two most important corporate jurisdictions in the country.⁴⁷⁹ Furthermore, quantified guidelines are not lacking. For example, the SEC's Form 8-K, which provides for the reporting of

476. Cf. *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 143 N.W.2d 374 (1966).

477. Thus the Louisiana sale-of-substantially-all-assets section provides that "Nothing in this Section is intended [to require shareholder approval if] the corporate business is not substantially limited, or if the proceeds . . . are appropriated to the conduct or development of [the corporation's] remaining businesses." LA. REV. STATS. § 12:41 (1951).

478. N.Y. STOCK CORP. LAW § 20 (McKinney 1951). Similarly, the Maine statute covers any sale of property "essential to the conduct of [the] corporate business and purposes." MAINE REV. STAT. ANN. tit. 13, § 241 (1965).

479. See note 184 *supra*. It has been said that most of the litigation in the sale-of-substantially-all-assets area arose under the former New York statute. Note, *Dispositions of Corporate Assets*, *supra* note 461, at 964 n.46. However, many of the New York cases concerned problems which can arise even under a substantially-all test, such as whether the

material corporate events, states that a "disposition shall be deemed to involve a significant amount of assets (i) if the net book value of such assets or the amount . . . received therefore . . . exceeded 15 percent of the [transferor's] total assets . . . or (ii) if it involved the . . . disposition of a business whose gross revenues for its last fiscal year exceeded 15 percent of the [transferor's] aggregate gross revenues. . . ."480 This test generally corresponds to the tests laid down by Ohio and the major stock exchanges for the materiality of an acquisition, tests which are also relevant to the problem at hand.

(c) *A statutory solution.*—In order to eliminate the uncertainty problem a statutory test, similar to the SEC test just quoted, would be highly desirable for determining whether shareholder approval was required for a sell-off. But appraisal rights should be treated as a separate question. A transaction may be important enough to require shareholder approval, but not important enough to trigger appraisal, and a sale of 15 percent of operating assets may be such a case.⁴⁸¹ On the other hand, where, for example, one of a corporation's two equal businesses is sold, the transaction seems to involve a radical economic restructuring of the enterprise and should trigger appraisal rights. Perhaps the answer is to lay down one figure, say 15 percent, for triggering voting rights, and another figure, say 33 percent, for triggering appraisal rights.

2. *Corporate Contractions or Partial Liquidations*

So far we have considered only the case where the proceeds of a sell-off are retained by the transferor, so that the only immediate effect of the transaction is to reduce the scale of the transferor's operations. Frequently, however, a sell-off is accompanied by a distribution of the proceeds to the transferor's shareholders. In such cases the transaction constitutes not merely a contraction of operations, but a contraction or partial liquidation of the entire enterprise.⁴⁸²

Such a contraction may result from business motives: Perhaps the corporation could not advantageously reinvest the proceeds of the sell-off, or perhaps the corporation is slowly liquidating by selling off

transfer was made in the ordinary course of business. *See, e.g., Eisen v. Post*, 3 N.Y.2d 518, 146 N.E.2d 779 (1957).

480. Form 8-K, Item 2, Instruction 4. *See also* Regulation S-X, 17 C.F.R. § 210.1-02 (k) defining the term "significant subsidiary" to include a subsidiary whose assets, or sales and operating revenues, exceed 15 percent of the assets or revenues of the parent and its subsidiaries on a consolidated basis.

481. *Cf. Veto Message*, N.Y. STATE LEGIS. ANNUAL 1953, 365-66.

482. Such transactions are probably most common in privately held corporations but also

its businesses one by one. However, tax motives may also play a prominent role. Corporate distributions are normally taxed as dividends at ordinary income rates, provided the distribution is covered by earnings and profits accumulated in prior years or generated in the current year.⁴⁸³ This tax treatment produces shareholder pressure to find methods of making distributions that will be taxed either not at all or at capital gains rates.⁴⁸⁴ One method is to completely liquidate the corporation, since distributions in complete liquidation are normally given capital gains treatment.⁴⁸⁵ But as long as the goose is laying golden eggs the shareholders may wish a more palatable alternative. Congress has thoughtfully provided several. One is set forth in sections 331 and 346 of the Code, which provide that certain distributions to shareholders made in connection with the termination of a corporate business may qualify as distributions "in partial liquidation" and be taxable at only capital gains rates.⁴⁸⁶ Such distributions leave the shareholder in the best of all possible economic worlds, retaining stock in a going corporation, and receiving capital gains cash. Thus the tax laws powerfully reinforce, if in fact they do not shape, the motives generating corporate contractions.

(a) *Under the traditional corporate statutes.*—Do such transactions require shareholder approval? Most corporate statutes do not explicitly cover them. If they are nevertheless to be squeezed within the statutory mold they must first be divided into their component parts: the disposition of the business and the distribution of the proceeds.

Whether the disposition required shareholder approval under the statutes would depend on whether it fell within the sale-of-substantially-all-assets provisions. As we have seen, those provisions are probably inapplicable to the sale of a significant business where, as in the case of a corporate contraction, another is retained.⁴⁸⁷ Whether the distribution required shareholder approval under the

occur in publicly held corporations. See, e.g., Notice of Annual Meeting of Stockholders and Proxy Statement of The Murray Corporation of America, November 14, 1963.

483. INT. REV. CODE of 1954, §§ 301(a), (c)(1), 316(a). If the distribution is made out of accumulated (rather than current) earnings and profits, it will be taxed as a dividend only if the earnings and profits were accumulated after February 28, 1913, but this limitation seldom comes into play. See B. BITTKER & J. EUSTICE, *supra* note 329, at 145.

484. See S. SURREY & W. WARREN, FEDERAL INCOME TAXATION—CASES AND MATERIALS 1223 (1962).

485. INT. REV. CODE of 1954, § 331(a)(1).

486. Moreover, a portion of the shareholder's basis in his stock will be allocated to the distribution so that the capital gains tax is applicable only to the amount, if any, by which the distribution exceeds the allocated portion of basis. See note 500 *infra*.

487. See text accompanying notes 469-71 *supra*.

statutes would depend on the amount of surplus legally available for distribution to shareholders by board action alone. If such surplus equalled the amount of the proposed distribution, board action would suffice. If not, and assuming there was no prohibition on the distribution of reduction surplus, capital would have to be reduced to create reduction surplus sufficient to cover the distribution. Shareholder action would normally⁴⁸⁸—although not invariably⁴⁸⁹—be required to effect such a reduction, although once the necessary reduction surplus was created the directors could distribute it without any further shareholder approval in many states.⁴⁹⁰ (However, Illinois and Pennsylvania require separate shareholder approval for such a distribution, and so does the Model Act in the absence of a contrary provision in the certificate.⁴⁹¹)

(b) *Under common law principles.*—But a sounder way to approach corporate contractions is to frankly recognize that they are not covered by the statutes and ask whether shareholder approval should be required under common law principles. We have seen that a strong case can be made for requiring shareholder approval for the sale of a significant business even if it is not accompanied by a related distribution. The primary argument against requiring shareholder approval in that case is that such a transaction merely constitutes a reshuffling of the form in which a portion of corporate assets are held. But this cannot be said of a corporate contraction, which by hypothesis involves a significant and probably permanent reduction in the nature and scale of the enterprise's activity, and shareholder approval of corporate contractions should therefore be required under common law principles.

Such a requirement would probably not make much change in present corporate practice. Even now, shareholder approval is needed

488. See, e.g., CAL. CORP. CODE § 1904 (West Supp. 1968); DEL. CODE ANN. tit. 8, § 244(b) (1967); ILL. ANN. STATS. ch. 32, § 157.59 (1954); PA. STAT. ANN. tit. 15, § 1706 (1967).

489. See, e.g., N.Y. BUS. CORP. LAW § 516 (McKinney 1963); ABA MODEL BUS. CORP. ACT ANN. § 62 (1960).

490. See, e.g., CAL. CORP. CODE § 1500(c) (West Supp. 1968); DEL. CODE ANN. tit. 8, § 170 (1967); N.Y. BUS. CORP. LAW § 510(c) (McKinney 1963). Such distributions may be subject to various safeguards. Thus California requires that shareholders be notified that a distribution is out of capital surplus, prohibits the distribution of reduction surplus to common shareholders when there is preferred outstanding, and prohibits any distribution of reduction surplus unless the board determines that it will not cause insolvency and that the fair value of the assets remaining will equal at least 1-1/4 times debts and liabilities. CAL. CORP. CODE §§ 1500, 1907 (West 1954).

491. See text accompanying notes 501-25 *infra*; ABA MODEL BUS. CORP. ACT ANN. § 41(b) (1960).

when capital must be reduced to free up funds for distribution. In most cases it will also be needed if the shareholders want the benefits of section 346 of the Internal Revenue Code, because in order to qualify under section 346 a distribution must be "in redemption of a part of the stock of the corporation pursuant to a plan . . ."⁴⁹² This requirement is normally satisfied through a voluntary pro rata surrender of shares, or a reverse stock split effecting an involuntary contraction of the number of outstanding shares. The Internal Revenue Service also permits it to be satisfied through a reduction in the per share par value of outstanding shares.⁴⁹³ The first method implies informal shareholder agreement; the other two require amendment of the corporation's certificate and therefore require formal shareholder approval.

492. INT. REV. CODE of 1954, § 346(a)(2). It is arguable that a redemption is not required under section 346(a)(2) if the tests laid down by section 346(b) are met. Section 346(a)(2) provides that a distribution shall be treated as in partial liquidation if it "is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year . . . including (but not limited to) a distribution which meets the requirements of subsection (b)" (emphasis added). Subsection (b) does not in terms require a redemption or plan, but provides that "a distribution shall be treated as a distribution described in subsection (a)(2)" if it "is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized" and immediately thereafter the corporation is actively engaged in the conduct of another such trade or business. It is therefore arguable that a distribution which meets the two-business test falls within section 346(b), and therefore within section 346(a)(2), even without a redemption or a plan. However, the Service does not so read the section, apparently on the theory that section 346(b) is only intended to provide a mechanical alternative to the "not essentially equivalent to a dividend" clause of Section 346(a)(2), and does not affect the redemption and plan provisions. This is probably a correct interpretation of legislative intent. *Cf. Hearings on the Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the Committee on Ways and Means of the House of Representatives*, 86th Cong., 1st Sess. 535 (1959). On the other hand, the redemption requirement does not appear to make tax sense. See note 500 *infra*.

493. See Notice of Annual Meeting of Stockholders and Proxy Statement of The Murray Corporation of America, November 14, 1963, at 3-4, 6; *cf.* *Fowler Hosiery Co. v. Commissioner*, 301 F.2d 394, 397 (7th Cir. 1962). There is no express warrant in section 346 for permitting a reduction in par value to substitute for a redemption, but there is some slight support for this approach in the legislative and administrative history. The House version of the 1954 Code provided in a definitional section that a distribution of property accompanying a reduction of capital should be treated as a distribution in redemption. Although the Senate Committee dropped this provision, it stated that "no inferences are to be drawn by the elimination of this provision . . . as to the status of existing law in this area." S. REP. NO. 1622, 83d Cong., 2d Sess. 252 (1954). The proposed regulations under section 317, a definitional section, included a provision that a reduction of capital constituted a redemption, *see* Proposed Treas. Reg. § 1.317-2, 19 Fed. Reg. 8254 (1954), but this provision was not included in the final regulations. *See* Treas. Reg. § 1-317 (1955). *See generally* B. BITTKER & J. EUSTICE, *supra* note 329, at 312-13. Perhaps the Service's approach can best be rationalized on the theory that the only significant result of a pro rata redemption is the consequent alteration of the corporation's capital structure, which will also result from a reduction of capital.

In theory, at least, a fourth method is available which might not require shareholder approval—a purchase by the corporation of the necessary amount of stock. However, state law may impose restrictions on the power of a corporation to purchase its own stock,⁴⁹⁴ and such purchases will be also subject to Rule 10b-5 under the Securities Exchange Act, giving rise to possible liability if the corporation fails to disclose a material fact.⁴⁹⁵ Furthermore, section 13(e) of the Securities Exchange Act empowers the SEC to prescribe rules to govern purchases of their own stock by corporations whose stock is registered under that Act. Since the section was recently amended at the Commission's own instance,⁴⁹⁶ it will probably soon issue rules to cover such transactions.⁴⁹⁷ Nor are these the only problems raised by such purchases. If they are consummated through private agreements with less than all of the shareholders, they may be subject to attack by nonparticipating shareholders on the ground of discriminatory treatment.⁴⁹⁸ If they are consummated over a stock exchange or on the open market they would probably not be subject

494. See OHIO REV. CODE ANN. tit. 17, § 1701.35 (Supp. 1966).

495. See *Kohler v. Kohler Co.*, 208 F. Supp. 808, 820 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); *Northern Trust Co. v. Essaness Theaters Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952) (sub silentio); DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS 24 (J. Flom, B. Garfinkel, J. Freund eds. 1967); Comment, *Rule 10b-5 and Purchase by a Corporation of its Own Shares*, 61 NW. U.L. REV. 307 (1966). Arguably, a reverse stock split may also fall within Rule 10b-5, *cf. Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1967), but that jump has not yet been made.

496. See H.R. Rep. No. 1711, 90th Cong., 2d Sess. (1968); Cohen, *A Note On Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAWYER 149, 154-56 (1966).

497. Temporary regulations of limited applicability have already been promulgated under amended section 13(e). See SEC Releases cited in note 407 *supra*. If the redemption is effected through an exchange requiring shareholder approval, the Proxy Rules would be applicable. Whether more detailed information will be required under 13(e) than would be required for a comparable shareholder-approved transaction under the Proxy Rules remains to be seen.

498. *Cf. Iback v. Elevator Supplies Co.*, 118 N.J.Eq. 90, 93, 177 A. 458, 459 (Ch. 1935); *General Inv. Co. v. American Hide & Leather Co.*, 98 N.J.Eq. 326, 331, 129 A. 244, 246 (Ct. Err. & App. 1925); *Theis v. Durr*, 125 Wis. 651, 104 N.W. 985 (1905); *Herwitz, Stock Redemptions and the Accumulated Income Tax*, 74 HARV. L. REV. 886, 894 (1961); *Israels, Are Corporate Powers Still Held in Trust?*, 64 COLUM. L. REV. 1446, 1452-53 (1964); Note, 41 GEO. L.J. 255 (1953).

Section 244(a)(3) of the Delaware statute provides that capital can be reduced pursuant to shareholder approval by "purchasing shares for retirement . . . at private sale," DEL. CODE ANN. tit. 8, § 244(b) (1967), and in *Martin v. American Potash & Chemical Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952), it was held that under this provision a corporation could, pursuant to shareholder approval, retire shares through a private purchase agreement on a non-pro rata basis; but neither the holding nor the language of the case cover a situation where the statute does not specifically provide for private purchase. See *Cheff v. Mathes*, 41 Del. Ch. 494, 505, 199 A.2d 548, 554 (Sup. Ct. 1964); *Bennett v. Propp*, 41 Del. Ch. 14, 21, 187 A.2d 405, 409 (Sup. Ct. 1962); Note, 41 GEO. L.J. 255, 258 (1953). In the absence of shareholder approval or specific statutory authorization, it seems likely that the burden would be on the

to attack on this ground,⁴⁹⁹ but they might artificially drive up the price of the stock and subject management to a charge of waste. The purchase price can be kept stable by consummating the purchases through a tender offer to all shareholders, but the amount of the resulting distribution would then necessarily be uncertain (depending on the number of accepting shareholders), and if it turned out to be significantly less than the proceeds "attributable to" the disposition within the meaning of section 346(a), the distribution might not qualify for section 346 treatment.

Although shareholder approval of corporate contractions may therefore normally be required as a practical matter because of the operation of the tax laws, it nevertheless seems advisable to require such approval under the corporate statutes, partly because the redemption requirement of section 346 is fortuitous and unnecessary, and may therefore be dropped,⁵⁰⁰ and partly because there may be cases where corporate contractions are not intended to qualify under section 346. On the other hand, it is questionable whether corporate contractions should trigger appraisal rights. Although they may result in a drastically restructured enterprise, an integral part of the restructuring is the release to the shareholder of a significant portion of his capital, and the appraisal right may therefore not be as important as it is in a transaction involving a rededication of the shareholders' entire capital investment to a drastically restructured enterprise.

board to convince the court that there was a legitimate reason for the lack of evenhandedness. Cf. *Cheff v. Mathes*, *supra*, at 504-05, 199 A.2d at 409; N. LATTIN, R. JENNINGS & R. BUXBAUM, *CORPORATIONS: CASES AND MATERIALS* 598 (4th ed. 1968).

499. See *Downs v. Jersey Central Power & Light Co.*, 115 N.J.Eq. 448, 451, 171 A. 306, 307 (Ch. 1934).

500. The redemption requirement appears to be purely vestigial in nature, deriving from the pre-1954 Code provisions, which on their face turned on the presence of a redemption rather than on the underlying economic realities. See text accompanying notes 504-16 *infra*. The comparable provisions of the 1954 Code purport to turn on economic realities, and the rationale of section 346 appears to be that a distribution stemming from a corporate contraction should not be treated like an ordinary dividend. Once that rationale is accepted, there is no reason for insisting that the distribution take the form of a redemption, particularly when that form can be satisfied by transactions which have virtually no economic significance, such as a pro rata surrender of stock or a reverse stock split. The Internal Revenue Service has implicitly recognized the meaninglessness of redemptions in this context by ruling that in determining what portion of a shareholder's total basis should be allocated to a section 346 distribution, the number of shares actually surrendered should be disregarded, and instead "the total number of shares *deemed* to have been surrendered [shall be] that number which bears the same ratio to the total number of shares outstanding as the cash distributed bears to the total fair market value of the net assets of the corporation immediately prior to the distribution." Rev. Rul. 56-513, 1956-2 CUM. BULL. 191, 192 (emphasis added). Similarly, where the redemption requirement is satisfied by a reduction of capital the Service has ruled that in determining the portion of basis

(c) *An excursus: the statutory partial liquidation provisions.*—The discussion so far has assumed that the statutes have not directly dealt with partial liquidations. In most cases this is certainly true. But the Illinois and Pennsylvania statutes do refer to “partial liquidations.” Section 157.41a of the Illinois corporation law,⁵⁰¹ entitled “Dividends in Partial Liquidation,” provides that “[a] corporation, from time to time, may distribute a portion of its assets, in cash or kind, to its shareholders as a liquidating dividend,” if the distribution has been recommended by the board and approved by the holders of two-thirds of the outstanding shares of each class of stock. Section 1703 of the Pennsylvania law,⁵⁰² entitled “Distributions in Partial Liquidation,” provides that “the board . . . may, from time to time, distribute to . . . shareholders in partial liquidation, out of unrestricted capital surplus . . . a portion of its assets, in cash or property,” if the distribution has been authorized by the shareholders.⁵⁰³

Does the term “partial liquidation” as used in these provisions refer to corporate contractions, as in the Internal Revenue Code? To answer this question we must briefly review the history of the term in the Code.

(i) *The Internal Revenue Code.*—We have seen that corporate distributions are normally taxable at ordinary income rates. If, however, a shareholder sells a portion of his stock to a third person, the proceeds are normally taxable at capital gains rates. But suppose the shareholder transfers his stock to the corporation itself, in exchange for cash or property, rather than to a third person? Should such a transaction be viewed as a distribution to the shareholder, taxable as a dividend, or as a sale of stock, taxable at capital gains rates?⁵⁰⁴

In the Revenue Act of 1924 Congress acted on this problem, and introduced the term “partial liquidation” into the tax laws, by providing that

to be allocated to the distribution the amount of the reduction of capital should be disregarded, and instead the calculation should be based on the ratio between the per-share distribution and the average per-share market price on the effective date of the plan. See Notice of Annual Meeting and Proxy Statement of The Murray Corporation of America, November 14, 1963, at 6.

501. ILL. ANN. STAT. ch. 32, § 157.41a (Smith-Hurd 1954).

502. PA. STAT. ANN. § 1703 (1967).

503. “Unrestricted capital surplus” is defined by PA. STAT. ANN. tit. 15, § 1002(3) (1967) to include paid-in, reduction, contributed, reacquisition, and revaluation surplus. The Illinois and Pennsylvania statutes both provide that such distributions cannot be made unless certain financial conditions, designed for the benefit of preferred shareholders, are satisfied.

504. B. BITTKER & J. EUSTICE, *supra* note 329, at 272-73.

[A]mounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock [i.e., rather than as distributions] As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.⁵⁰⁵

The meaning of these provisions was highly uncertain. "Partial liquidation" was a new term with no established significance in either corporate or tax law.⁵⁰⁶ "Redemption" was an accepted term in corporate law; however, in corporate parlance it ordinarily referred to an acquisition of securities which were subject to compulsory reacquisition by their terms,⁵⁰⁷ and was therefore not usually applied to a repurchase of (noncallable) common,⁵⁰⁸ while in the Revenue Act the term apparently included all methods of reacquisition and all types of stock.

Given these terminological ambiguities, and the general vagueness of the provisions, the statute was susceptible of at least four interpretations, not necessarily mutually exclusive:

(1) The provisions might have encompassed all corporate reacquisitions of stock.⁵⁰⁹ However, many reacquisitions are the precise economic equivalent of a dividend—for example, reacquisitions of a portion of every shareholder's stock on a substantially pro rata basis. Such an interpretation would therefore have created an enormous loophole in the tax laws. Also, such an interpretation would have given little or no meaning to the term "partial liquidation," except perhaps as a pure term of art.

(2) The provisions might have encompassed corporate reacquisitions of stock resulting in a complete termination or substantially disproportionate reduction of a shareholder's interest in the corporation. Capital gains treatment could be justified for such a transaction, since its economic effect on the shareholder is comparable to that of a sale to a third person. Use of the term "partial liquidation" could also be justified, albeit tenuously, on the ground that its economic effect on the shareholder is comparable to that of a

505. INT. REV. CODE of 1924, ch. 234, §§ 201(c), (g), 43 Stat. 253, 255 (1924).

506. See Herwitz, *supra* note 498, at 886-87.

507. See A. FREY, C. MORRIS, & J. CHOPER, *CASES AND MATERIALS ON CORPORATIONS* 936 (1966).

508. See N. LATTIN, R. JENNINGS, & R. BUXBAUM, *supra* note 498, at 1408.

509. See H.R. REP. NO. 1, 69th Cong., 1st Sess. 5 (1925), S. REP. NO. 52, pt. 1, 69th Cong. 1st Sess. 15 (1926).

complete liquidation. To use Professor Herwitz's description, "Such a transaction could well be regarded as a 'partial liquidation'—a vertical rather than horizontal partial liquidation."⁵¹⁰

(3) The provisions might have encompassed reacquisitions made in connection with financial events at the corporate level—specifically, reacquisitions made out of capital surplus, and more particularly, out of reduction surplus resulting from a reduction of capital. Such an interpretation would explain use of the term "partial liquidation," since a distribution out of capital surplus, and particularly reduction surplus, could be viewed as a partial return of capital and therefore as a partial liquidation of the corporation. It would not make too much tax sense, however, because a distribution covered by earnings and profits should not escape dividend treatment simply because it accompanies a simultaneous (and probably unnecessary) reduction of capital, while a distribution not so covered would be nontaxable in any event.⁵¹¹

(4) The provisions might have encompassed reacquisitions made in connection with business events at the corporate level—specifically, corporate contractions. (Indeed, it is easy to confuse the business event, corporate contraction, with the financial event, reduction of capital, since the two events are frequently related.) Capital gains treatment of such distributions could be justified on the theory that they are more like a distribution in complete liquidation or a return of capital than like an ordinary dividend.⁵¹² Also, such an interpretation would easily justify use of the term "partial liquidation."

To curb the tax avoidance possibilities inherent in some of these interpretations, Congress provided in 1926 that, "If a corporation cancels or redeems its stock . . . at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend"

510. Herwitz, *supra* note 498, at 897.

511. See *id.* at 888-91; cf. Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907, 910-11 (1941).

512. Cf. Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1, 5-9 (1958). More objective rationales for giving capital-gains treatment to distributions resulting from corporate contractions have also been advanced: for example, that if the disposed of business had originally been placed in a separate corporate entity, the sale and distribution would have constituted a complete liquidation, and the tax laws are justified in treating the transaction as if that had been the case. These theories have been shot down about as fast as they have been sent up. See Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 471-73 (1950); Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 36-38 (1952).

it would be treated as such.⁵¹³ Speaking very generally, the rules that emerged under this statutory pattern were that a non-pro rata redemption would be given capital gains treatment, while a pro rata redemption would be given dividend treatment unless it resulted from certain types of events at the corporate level, in particular, from a corporation contraction.⁵¹⁴

As these rules emerged, it became clear that the statute, as interpreted, had aggregated two issues that needed very different treatment—redemptions which might qualify for capital gains treatment because they effected a complete termination or substantially disproportionate reduction of a particular shareholder's interest, and distributions which might qualify for capital gains treatment because they were made in connection with a corporate contraction or other relevant corporate event. The draftsmen of the 1954 Code attempted to separate out these two issues:⁵¹⁵ complete or substantially disproportionate redemptions were covered by section 302 ("Distributions in Redemption of Stock"), while distributions in connection with "events at the corporate level"—in particular, corporate contractions—were covered by sections 331(a)(2) and 346 ("Partial Liquidation Defined").⁵¹⁶

513. INT. REV. CODE of 1926, ch. 27, § 201(g), 44 Stat. 9, 11 (1926) (now INT. REV. CODE of 1954, § 302). A much more limited version of this provision had appeared in prior Revenue Acts. See INT. REV. CODE of 1921, ch. 136, § 201(d), 42 Stat. 227, 228-29 (1921) (now INT. REV. CODE of 1954, § 302); INT. REV. CODE of 1924, ch. 234, § 201(f), 43 Stat. 253, 255 (1924) (now INT. REV. CODE of 1954, § 302); Murphy, *Partial Liquidations and the New Look*, 5 TAX L. REV. 73, 75 (1949).

514. See B. BITTKER & J. EUSTICE, *supra* note 329, at 274-76; Bittker & Redlich, *supra* note 512, at 468-72.

515. "Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 or 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.

"Your committee . . . separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in part 1 of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation." S. REP. NO. 1622, 83d Cong., 2d Sess. 49 (1954).

516. Section 346(a)(2) provides that a distribution shall be treated as in partial liquidation if it "is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year . . . , including (but not limited to) a distribution which meets the requirements of subsection (b)." Section 346(b)

(ii) *The Illinois statute.*—Returning now to the corporate statutes, section 157.41a of the Illinois statute was enacted in its present form in 1945,⁵¹⁷ and to the extent the draftsmen intended “partial liquidation” to have the same meaning as in the Internal Revenue Code, they must have contemplated the pre-1954 Code provisions.⁵¹⁸ Under those provisions, “partial liquidation” might have had any of four separate meanings. It may be assumed that the draftsmen of section 157.41a intended at least one of these, if only because they virtually exhaust the possible referents of the term. But which? There is little to indicate that the draftsmen intended to refer to all reacquisitions, or even to complete or substantially disproportionate redemptions, since purchases and redemptions of a corporation’s own stock are specifically dealt with in other sections of the statute,⁵¹⁹ and in any event calling all such transactions “partial liquidations” severely strains the meaning of the term. Section 157.41a therefore seems to refer to distributions made in connection with certain events at the corporate level. The problem is, does it have a business meaning—that the distribution results from a contraction of operations; a financial meaning—that the distribution is made out of capital surplus; or both? The financial interpretation seems the most likely when section 157.41a is read in conjunction with section 157.41. Entitled “Dividends,” that section prohibits the payment of dividends on common stock out of paid-in surplus (defined by section 157.2-12 to include reduction surplus), except for “the distribution of assets as a liquidating dividend.” Since section 157.41a uses this same term in providing that “a corporation . . . may distribute a portion of its assets . . . as a liquidating dividend,” the two sections read together seem to mean that the board cannot make a distribution to common out of paid-in surplus (section 157.41) unless the shareholders approve

furnishes a relatively safe harbor from this troubled sea by providing that a distribution “shall be treated as a distribution described in subsection (a)(2) if . . . [it] is attributable to the corporation’s ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution” by the corporation (or, in certain cases, by a predecessor in interest) and the corporation retains at least one other such business.

Actually, notwithstanding the Senate Report, sections 302 and 346 are not explicitly limited to events at the shareholder and corporate level, respectively. However, the language of the two sections is susceptible of that construction, and the sections are generally so read in light of the Report.

517. CHICAGO BAR ASS’N, ILLINOIS BUSINESS CORPORATION ACT ANNOTATED WITH FORMS 183 (2d ed. 1947).

518. The body of section 157.41a uses the term “liquidating dividend,” rather than “dividends in partial liquidation,” which is used in the title. See text accompanying note 501 *supra*.

519. ILL. ANN. STATS. ch. 32, §§ 157.6, 157.58 (Smith-Hurd 1954).

(section 157.41a). This interpretation is reinforced by the legislative history. The predecessor of section 157.41a made no mention of partial liquidations. Entitled "Regulations governing reduction of stated capital and distribution of assets," it provided that "paid-in surplus, whether created by reduction of capital or otherwise," could be distributed subject to shareholder approval and certain financial limitations, and that "each such distribution, when made, shall be identified as liquidating dividend."⁵²⁰ There is no indication that introduction of the term "partial liquidation" was intended to broaden the statutory coverage. On the contrary, the annotation to section 157.41a, prepared by the corporation law committee of the Chicago Bar Association, states that:

In practice, section [157.41a] is most frequently used for the distribution of paid-in surplus. . . . The term "dividends in partial liquidation" is used in the heading to [this] section *because dividends from paid-in surplus represent a distribution of part of the consideration received on the issuance of shares.* (Emphasis added.)⁵²¹

Of course the term "partial liquidation" as used in section 157.41a could be construed to include distributions in connection with corporate contractions, in addition to or instead of distributions out of paid-in surplus. Such an interpretation would accord with a straightforward reading of the term at least as well as the financial interpretation, perhaps better, and would also accord with one meaning of the term as it was used in the Internal Revenue Code prior to 1954 when the present section 157.41a was adopted. Moreover, such an interpretation would be desirable from a policy standpoint.⁵²² Nevertheless, it does not seem likely this was the meaning section 157.41a was intended to have.

(iii) *The Pennsylvania statute.*—Unlike section 157.41a, the present section 1703 of the Pennsylvania statute was adopted after enactment

520. CHICAGO BAR ASS'N, ILLINOIS BUSINESS CORPORATION ACT ANNOTATED WITH FORMS 237-40 (1934).

521. 1 CHICAGO BAR ASS'N *supra* note 517, at 184. The annotation continues: "Distributions of paid-in surplus under section [157.]41a may be from surplus created by reduction of stated capital . . . or from paid-in surplus otherwise created The formal reduction of paid-in surplus to reflect a dividend under section [157.]41a may be effected pursuant to section [157.]60a. In order to prevent the possible inference that the distribution is from earnings, subparagraph (g) requires the identification of the distribution as a liquidating dividend, thus complementing the provision of section [157.]41(b) requiring that the source of ordinary dividends out of paid-in surplus be disclosed to the shareholders receiving such dividends." *Id.*

522. See text following note 491 *supra*.

of the 1954 Code—in 1957. However, the use of the term “partial liquidation” in section 1703 seems to derive from the Illinois statute rather than from the Code, since section 1703 was based on section 41 of the Model Act,⁵²³ which in turn was based on the Illinois statute.⁵²⁴ The language of section 1703 even more strongly suggests a financial interpretation than the language of the Illinois statute, since it refers to distributions “in partial liquidation, *out of unrestricted capital surplus.*” (Emphasis added.) Like the Illinois provision, section 1703 follows a provision, section 1702, which normally prohibits distributions on common stock out of capital surplus. Reading section 1703 in light of its derivation, and in conjunction with section 1702, it seems fairly clear that the term “partial liquidation” is used synonymously with distributions out of capital surplus. Members of the Pennsylvania Bar Association’s corporation law committee, which drafted the provision, have indicated that this is the meaning intended.⁵²⁵

3. *The Creation of a Subsidiary*

Another major type of corporate division consists of a transfer of

523. Hackney, *The Pennsylvania Business Corporation Law Amendments*, 19 U. PITT. L. REV. 51, 73 (1957).

524. See Campbell, *The Model Business Corporation Act*, BUS. LAW., July 1956, at 98, 100; Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412, 424 (1952); Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 197-98 (1958). At that time Model Bus. Corp. Act § 41 was entitled “Distributions in Partial Liquidation.” See ABA COMM. ON CORP. LAWS, MODEL BUSINESS CORPORATION ACT (rev. 1953); 1 ABA MODEL BUS. CORP. ACT ANN. 708 (1960). However, in 1959, after the Pennsylvania statute had been adopted, the term “partial liquidation” was dropped from section 41 and its title was changed to “Distributions from Capital Surplus.”

Similarly, section 33-357 of the Connecticut Stock Corporation Law was until recently entitled “Distributions in partial liquidation,” and provided:

(a) The board of directors of a corporation may . . . distribute to its shareholders in partial liquidation, to the extent of the capital surplus of the corporation, a portion of its assets

(c) In the case of a corporation with shares of more than one class outstanding, no such distribution shall be made unless the certificate of incorporation so provides or such distribution is authorized by [two-thirds] of the outstanding shares of each class

However, in 1961 these references to “partial liquidation” were eliminated by changing the title to “Distributions charged to capital surplus” and amending subsection (a) to read:

Subject to the provisions of this section, the board of directors may . . . declare, and the corporation may, to the extent of its capital surplus, make, distributions . . . to its shareholders with respect to its outstanding shares or any thereof.

16 CONN. GEN. STATS. ANN., § 33-357 (Supp. 1968).

525. See Hackney, *supra* note 523, at 73; Mulford, *Corporate Distributions to Shareholders and other Amendments to the Pennsylvania Business Corporation Law*, 106 U. PA. L. REV. 536, 548-49 (1958).

assets to a subsidiary in exchange for the subsidiary's stock. In this section we will examine the typical case in which such a transfer is unaccompanied by a distribution of the subsidiary's stock to the parent's shareholders—creation of a subsidiary. (That is, the creation of a subsidiary as an enterprise. Such a transfer is preceded by legal steps creating the subsidiary as an entity.) Normally the assets so transferred comprise a business, although frequently this business will stand in a symbiotic or even parasitic relationship to that of the parent.

Such a transfer may be motivated by business or tax reasons. For example, the parent may wish to separate a risky business from a stable one; or to separate a regulated business from an unregulated one; or to separate an enterprise that does business in many states from one that does business in only a few so as (hopefully) to reduce the exposure of the latter to service of process and state taxation;⁵²⁶ or the parent may seek certain tax benefits under the Internal Revenue Code obtainable through the use of subsidiaries.⁵²⁷

(a) *Under the traditional corporate statutes.*—Is shareholder approval required for such transactions? The statutes, as usual, are cloudy. Prior to the end of the nineteenth century the power of one corporation to hold stock in another was shrouded in considerable doubt.⁵²⁸ Toward the end of that century New Jersey enacted a provision in her general corporation law expressly conferring such a power, and the other states soon followed suit.⁵²⁹ However, since the legislative purpose was simply to confer a power upon the corporation, these provisions normally do not specify the body within the corporation which is to exercise the power.

We are therefore remitted to common law principles, unless such transactions fall within the sale-of-substantially-all-assets provisions.

526. See B. BITTKER & J. EUSTICE, *supra* note 329, at 449; Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929); Painter, *Double Derivative Suits and Other Remedies with Respect to Damaged Subsidiaries*, 36 IND. L.J. 143, 143-44 (1961).

527. See, e.g., INT. REV. CODE of 1954, §§ 921-22, 931-34; Seghers, *The Western Hemisphere Trade Corporation—What It Is and How to Use It to Advantage*, 42 TAXES 582 (1964). See generally B. BITTKER & J. EUSTICE, *supra* note 329, at 670-89.

528. See J. BONBRIGHT & G. MEANS, *THE HOLDING COMPANY* 55-57 (1932); 2 A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 861-62 (5th ed. 1953); Note, *Power of a Corporation to Acquire Stock of Another Corporation*, 31 COLUM. L. REV. 281 (1931). See generally W. NOYES, *INTERCORPORATE RELATIONS* 472-509 (2d ed. 1909). This is not to say that the practice was unknown; a number of corporations had special charters empowering them to acquire and hold stock. See J. BONBRIGHT & G. MEANS, *supra*, at 58-64; Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125 (1940).

529. H. BALLANTINE, *supra* note 3, at 236-37; Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U.L.Q. 305, 307, 320-21 (1937).

Generally speaking, the considerations already developed in connection with the application of these provisions to other corporate divisions⁵³⁰ are applicable here. If, as is usually the case, the parent retains at least one significant business, the transaction would not seem to be a sale of "substantially all" assets. Indeed, it is questionable whether such a transaction would fall within these provisions even if a significant business is not retained, since it is not at all clear that an exchange of assets for stock in a wholly-owned subsidiary is a "sale."⁵³¹ By the same token, however, the sale-of-substantially-all-assets provisions should not be read to exclude by negative implication the necessity of shareholder approval if otherwise required.

(b) Under common law principles and de facto theory.—We are then brought to the question, should creation of a subsidiary require shareholder approval under common law principles? Such a transaction does not affect the amount or character of the assets under the transferor's ultimate control, nor does it usually affect the shareholders' position vis-a-vis either the corporate assets or management.⁵³² Usually, therefore, creation of a subsidiary is a business decision which should not require shareholder approval. But if the subsidiary's certificate differs materially from the parent's, or if the subsidiary retains authorized but unissued stock, a different result should follow. For example, if the subsidiary's purpose clause differs from the parent's, the transferred assets may be dedicated to a purpose impermissible to the parent. If the powers of the subsidiary's directors differ from those of the parent, ground rules relating to decisions on the employment of the transferred assets may be affected. If the subsidiary retains authorized but unissued stock, it may be possible for the board to create ownership rights in the transferred assets differing from the rights that could otherwise have been created without shareholder approval. In such cases creation of a subsidiary involves a structural decision and should be a shareholder matter under common law principles. Alternatively, the most basic

530. See text accompanying notes 457-76 *supra*.

531. The Pennsylvania statute specifically covers this question by requiring shareholder approval for "[a] sale . . . of all, or substantially all, the property and assets . . . of a corporation, whether to a subsidiary corporation or not . . ." § 1311(B), Purdon's Pa. Leg. Service. However, a "sale" to a wholly-owned subsidiary does not give rise to appraisal rights under the Pennsylvania statute unless "the preferences, qualifications, limitations, restrictions or special or relative rights, granted to or imposed upon the shares of any class of the parent corporation are . . . altered by such sale . . ." *Id.* § 1311(D).

532. This proposition assumes, as I shall argue in a subsequent article, that the parent's shareholders have the right to vote the subsidiary's stock on certain types of issues.

application of de facto theory would require shareholder approval in such cases under the statutory provisions relating to amendment of the certificate. One purpose of these provisions is to protect shareholders as a class by requiring shareholder approval. These provisions should therefore be read to prohibit the taking of an action which works a change on any material matter covered in the certificate (including an increase in the amount of authorized stock which may be issued as ownership claims against the corporation's assets) without the shareholder approval required for certificate amendment.

Many of these principles are illustrated by the recent case of *Aiple v. Twin City Barge and Towing Company*.⁵³³ Twin City was a Minnesota corporation engaged in the river-harbor transfer and docking business (comparable to car-switching in railroad yard terminals) at various locations in and around Minneapolis-St. Paul and Chicago. It also had a shipyard division which ran a maintenance and repair service for the barge equipment of Twin City and other companies. Twin City's management wanted to increase equity capital in order to expand its business and accordingly sought to amend the certificate so as to authorize additional shares of common stock. Aiple, who was the owner of more than one-third of Twin City's outstanding stock (and was also a director), objected.⁵³⁴ Under the Minnesota statute governing certificate amendment the amendment could not pass without his votes, and accordingly management determined upon the following plan: A new subsidiary was organized with authorized stock of 50,000 shares. The subsidiary's board consisted of Twin City's officers and two employees in its shipyard division. Twin City's board (with Aiple dissenting) voted to transfer to the subsidiary all the assets of the shipyard division, plus 5,000 dollars in cash for working capital, in exchange for 4,000 of the subsidiary's shares and the assumption by the subsidiary of the shipyard division's liabilities. It was apparently contemplated that the subsidiary would sell part of its 46,000 authorized but unissued shares, thereby indirectly increasing Twin City's capital. At the time of the transfer

533. 274 Minn. 38, 143 N.W.2d 374 (1966).

534. Aiple's motivation was unclear. Aiple claimed his objection was grounded on the opinion that expansion should be financed through earnings rather than through the issue of additional stock. Management claimed that Aiple's objection was grounded in his financial interest in a competitor of Twin City. See Comment, 51 MINN. L. REV. 1169, 1169 n.1 (1967). The court observed that "the effect of the defendant's plan is to diminish the interest of [Aiple], or force him to buy stock in a new corporation to protect his proportionate interest or investment." *Aiple v. Twin Barge & Towing Co.*, 274 Minn. 38, 45, 143 N.W.2d 374, 379 (1966).

the shipyard division accounted for roughly 30 percent of Twin City's gross income, 10 percent of its fixed assets, and five percent of its total assets.

Aiple brought suit to set aside the transfer and enjoin future transactions of this kind. Twin City defended on the basis of statutory and certificate provisions empowering the corporate acquisition of stock, and also argued that the Minnesota sale-of-substantially-all-assets provision permitted, by negative implication, a sale of less than substantially all assets without shareholder approval. The court held for Aiple, applying *de facto* theory, although not using that term:

. . . Under the circumstances in this case the defendant corporation has attempted to split itself into two corporations for the obvious purpose of increasing the capital stock of the parent company without complying with the provisions of the statute governing that subject. The parent corporation has divided its assets with its own creature, capitalized a portion at a fixed valuation, and received back all of the shares of the stock issued by the subsidiary. If this can be done, the provisions [governing amendment of certificates] may be circumvented to the point where a corporation might fragment itself into any number of divisions, thus leaving minority stockholders without the protection that the statute was designed to give them.⁵³⁵

The court further held that the empowering provisions relied on by management "refer to the ordinary business transactions of the corporation and do not extend to a reconstruction of the corporate body itself," and that the sale-of-substantially-all-assets provision does not authorize the sale of less than substantially all assets "under circumstances where the transfer interferes with the legal right of a minority stockholder."⁵³⁶

A dissenting judge in *Aiple* argued that,

535. 274 Minn. at 45, 143 N.W.2d at 378-79. See also *Klopot v. Northrup*, 131 Conn. 14, 37 A.2d 700 (1944); *Schwab v. E.G. Pöfter Co.*, 194 N.Y. 409, 87 N.E. 670 (1909); *Moore v. Los-Lúgos Gold Mines*, 172 Wash. 570, 21 P.2d 253 (1933).

536. *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 35, 44, 176 N.W.2d 374, 378 (1966). Aiple had sought not only to set aside the transaction in question, but to enjoin Twin City from further transfers of corporate assets to the subsidiary or any other corporation except in the ordinary course of business. The order of the trial court, which the supreme court affirmed, instead enjoined Twin City from making any further transfers which might materially alter Aiple's rights so long as he was the owner of one-third or more of Twin City's outstanding common stock. Apparently Aiple did not cross-appeal. The injunction gave him substantially the relief he requested, and the broader relief he originally requested was probably not warranted, since certain transfers of assets—for example, the sale of a tug for cash—might be out of the *ordinary* course of business, and yet constitute business decisions clearly within the board's power.

The majority opinion in effect holds that the transfer of a part of the assets of defendant corporation to a subsidiary for the purpose of obtaining needed financing to attain corporate objectives cannot be regarded as within the ordinary course of the corporation's business. . . . In my judgment the conduct of corporate business through corporate subsidiaries formed by the personnel of the parent corporation for various reasons, including tax avoidance as well as local financing, cannot be regarded as other than a common or ordinary manner of doing business.⁵³⁷

This argument misconceives the problem, which arose from the fact that the transaction in *Aiple* was not a "common or ordinary" method of doing business, nor was it motivated by common or ordinary business reasons. Where the creation of a subsidiary is so motivated, nothing in *Aiple* requires shareholder approval because there will be no need for a subsidiary which retains authorized but unissued stock, or whose certificate redistributes the powers of ownership and management or otherwise differs materially from the parent's certificate. If one of these factors is involved, the transaction is prima facie more than a "common or ordinary" method of doing business.

4. *Spin-Offs, Split-Offs, and Split-Ups*

In the preceding section it was assumed that while the parent desired to segregate certain of its assets in a subsidiary, it intended to retain ultimate control over those assets through retention of the subsidiary's stock. In some cases, however, the creation of a subsidiary may be followed by a distribution of its stock to the parent's shareholders. Where such a distribution is not pro rata, it is probably motivated by business reasons, most notably a desire to redistribute ownership interests to permit shareholders to go their separate ways, with each shareholder or shareholder group retaining one of the corporate businesses. Where such a distribution is pro rata, tax motives are likely to be in the forefront. We have already noted the pressure to generate distributions which will not be taxed at ordinary income rates, and seen that section 346 of the Internal Revenue Code provides one outlet for this pressure through partial liquidations. A similar outlet is provided by section 355 through spin-offs (simple distributions of stock in a subsidiary), split-offs (distributions of stock in the subsidiary in exchange for stock in the parent), and split-ups (distributions of the stock of two or more

537. *Id.* at 49, 176 N.W.2d at 381.

subsidiaries which together constitute all of the parent's assets).⁵³⁸ Broadly speaking, section 355 provides that such transactions will be tax-free if: (1) The parent distributes stock representing at least 80 percent of the subsidiary's voting stock by voting power and 80 percent of the total number of all of the subsidiary's other shares;⁵³⁹ (2) immediately after the distribution the parent and the subsidiary (or in a split-up, all of the subsidiaries) are engaged in the active conduct of a trade or business which has been actively conducted during the preceding five years by the parent or the subsidiary, or in certain cases by a corporate predecessor;⁵⁴⁰ and (3) the transaction is not used "principally as a device for the distribution of earnings and profits" of the parent or the subsidiary.⁵⁴¹

There is an obvious similarity between transactions qualifying under section 355 and partial liquidations qualifying under section 346, but there are important differences between the operation of the two provisions. In a partial liquidation the distribution consists either of the proceeds resulting from the sale of a business or of the assets of the business itself—in other words, either of cash or of tangible assets which presumably can be readily converted into cash. In a section 355 transaction the distribution consists of stock in a subsidiary and therefore does not put cash or tangible assets in the shareholders' hands, although it does enable shareholders to realize cash for part of their investment at capital gains rates—while retaining the balance in corporate solution—by selling their stock in, or liquidating, the distributed subsidiary.⁵⁴² Nevertheless, because it does not involve an immediate distribution of cash or tangible assets, a section 355 distribution is tax-free,⁵⁴³ while a distribution in partial liquidation is taxable when made, although only at capital gains rates.⁵⁴⁴

(a) *Under the traditional corporate statutes.*—Do spin-offs, split-offs, and split-ups require shareholder approval? None of the statutes under

538. See Siegel, *supra* note 466, at 535. As in the case of partial liquidations, such transactions are probably most common in the case of privately held corporations, but are by no means confined to such corporations. See *Spinning Faster?*, FORBES, March 15, 1968, at 46

539. INT. REV. CODE OF 1954, §§ 355(a)(1)(A), (D), 368(c). If the parent owns more voting and nonvoting stock in the subsidiary than this, it may retain the excess if it can satisfy the Internal Revenue Service that such retention is "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." *Id.*, § 355(a)(1)(D)(ii).

540. *Id.*, §§ 355(a)(1)(C), 355(b).

541. *Id.*, § 355(a)(1)(B).

542. But if a sale or exchange was arranged prior to, or occurs shortly after, the distribution, that fact will be viewed as evidence that the transaction was used principally as a device for the distribution of earnings and profits, Treas. Regs. § 1.355-2(b) (1955), although "the mere fact" that a sale or exchange occurs cannot be construed to mean it was used principally as such a device. INT. REV. CODE OF 1954, § 355(a)(1)(B).

543. INT. REV. CODE OF 1954, § 355(a)(1).

544. For other differences between the operation of sections 346 and 355, see Whitman,

direct consideration explicitly deal with such transactions. If they are nevertheless to be squeezed within the statutory mold, they must therefore be broken down into their component parts—the transfer and the distribution.

(i) *The transfer.*—The transfer raises similar problems in all three cases. The sale-of-substantially-all-assets provisions would seem inapplicable to the transfer in a spin-off or split-off, which normally involves less than substantially all of the parent's operating assets. In the case of a split-up, however, all of the parent's assets are held by subsidiaries, and at some point the parent must therefore have transferred to one or more subsidiaries substantially all the operating assets it then owned. Nevertheless, it seems questionable whether even this transfer would necessarily require shareholder approval. First, a transfer of assets to a subsidiary does not seem to be a "sale" within the meaning of the sale-of-substantially-all-assets provisions, since ultimate control is retained by the parent. Second, if the transfers take place over a period of time, at the time of the last transfer the parent, although it may not own any operating assets directly, will own a substantial amount of such assets indirectly through its ownership of previously created subsidiaries. Even if a transfer of assets to a subsidiary is a "sale," it is probably not a sale of "substantially all" of the parent's assets if the parent also owns significant operating subsidiaries which it does not transfer.

(ii) *The distribution*

(A) *Split-ups.*—The distribution in a split-up consists of all of the transferor's assets, and therefore constitutes a complete liquidation. Although the statutes all require shareholder approval for "dissolution," in theory it is arguable that complete liquidation does not, in and of itself, require shareholder approval, because in best usage the term "dissolution" probably should be restricted to termination of the legal entity, while the term "liquidation" should be reserved for termination of the underlying enterprise.⁵⁴⁵ However, it seems likely that in requiring shareholder approval for "dissolution" the legislatures were not following this ideal usage, but intended to require shareholder approval for termination of either the entity or the

Draining the Serboman Bog: A New Approach to Corporate Separations Under the 1954 Code, 81 HARV. L. REV. 1194, 1210-11 nn.83-84 (1968).

545. Cf. G. HORNSTEIN, CORPORATION LAW AND PRACTICE §§ 771-76 (1959).

enterprise.⁵⁴⁶ In any event, as a practical matter liquidation of the enterprise is almost invariably accompanied by dissolution of the entity, because, among other reasons, if the entity is not dissolved, franchise fees will often continue to accumulate.⁵⁴⁷

(B) *Split-offs*.—The distribution in a split-off is made in exchange for stock in the parent. Such a distribution therefore raises problems similar to those raised by partial liquidations since the latter also normally involve a surrender of stock for tax reasons. If the exchange of stock in a split-off is pro rata, either all the shareholders must informally approve the split-off by agreeing to hand in a portion of their stock, or there must be a reverse stock split, which requires formal shareholder approval. If the exchange is not pro rata (and usually it is not, since the result of a pro rata exchange can be more easily accomplished through a spin-off or split-up), shareholder approval would be required if the value of the subsidiary's stock exceeded the amount of surplus legally available for distribution by the board, since in that case a reduction of capital would be necessary. Even when there is sufficient surplus available for distribution by the board, if the distribution is not pro rata shareholder approval would probably be obtained as a practical matter to avoid charges based on discriminatory or unfair treatment. A nondiscriminatory non-pro rata split-off might in theory be accomplished by making a tender offer to all of the parent's shareholders to exchange stock in the subsidiary for stock in the parent. However, this would be risky because under section 355 the distribution must consist of at least 80 percent of the subsidiary's stock by voting power and shares, and if the tender offer was not fully subscribed the transaction might therefore be taxable.

(C) *Spin-offs*.—The distribution in a spin-off involves neither a complete liquidation nor an exchange of stock. Shareholder approval would therefore not be required under the statutes unless the value of the distributed shares exceeded the surplus legally available for distribution by the board, so that a reduction of capital was necessary.

(b) *Under common law principles*.—Of the three transactions—spin-offs, split-offs, and split-ups—only split-ups invariably require shareholder approval under the corporate statutes. Since neither spin-

546. Cf. *Doe Run Lead Co. v. Maynard*, 283 Mo. 646, 223 S.W. 600 (1920).

547. See G. HORNSTEIN, *supra* note 544, at 289-90; *Federal Crude Oil Co. v. State*, 169 S.W.2d 283 (Tex. Civ. App.), *cert. denied*, 320 U.S. 758 (1943).

offs nor split-offs are explicitly covered by the statutes, the question arises whether they should require shareholder approval under common law principles.

We have seen that such approval should be required for a partial liquidation if a significant business is involved. A spin-off or split-off involving a significant business presents an even more compelling case for requiring shareholder approval. After a partial liquidation the relationship between the shareholders and the assets which the corporation retains remains unchanged, while the assets which the corporation distributes come into the shareholders' immediate control. After a spin-off or split-off, however, the distributed assets are no closer to the shareholders than they were before; they are still separated by a corporate shell. Furthermore, the shell is that of a new corporation, which will have, at that point or in the future, different shareholders and a different management. "What was once an integrated business becomes legally separated immediately after the corporate division and, in time, economically separated. For this reason alone, stockholder vote would seem appropriate,"⁵⁴⁸ at least assuming that the transaction is an economically significant one.

(c) *Under de facto theory.*—Shareholder approval may also be required for a spin-off or split-off under de facto theory if it involves the creation of a subsidiary whose certificate differs materially from the parent's, or which retains authorized but unissued stock. Thus in *Klopot v. Northrup*,⁵⁴⁹ Newman Company, which was engaged in the manufacture and sale of corsets, proposed to transfer the assets of its surgical-corset division and cash to Miles Company, a corporation which it had organized, in exchange for Miles preferred and common stock. Under the plan, Newman would retain the preferred and distribute the common as a dividend to Newman shareholders. Various business reasons were advanced for the transfer, including the fact that distribution channels for surgical corsets differed from Newman's normal distribution channels.

Miles' certificate contained two material provisions not present in Newman's: that its shareholders would have no preemptive rights, and that a contract approved by majority vote of the shareholders present at a meeting called for that purpose would be as valid as if all shareholders had approved, whether or not it would be otherwise open to legal attack "because of directors' interest or for any other reason." (Miles' board would consist of five directors including three

548. Siegel, *supra* note 466, at 569.

549. 131 Conn. 14, 37 A.2d 700 (1944).

Newman directors who, with their families, owned just under two-thirds of Newman's stock.) Plaintiff, a shareholder in Newman, attacked the transaction as illegal. The court agreed, on the ground that the Miles certificate would work a significant change in Klopot's rights vis-a-vis the transferred assets:

The reason why a stockholder . . . has . . . a pre-emptive . . . right . . . is that his ownership of a certain number of shares entitles him to a certain part in the assets and management of the corporation, and he is entitled of right to the opportunity to preserve his proportionate voice and interest. . . . As regards the business of manufacturing and selling the Miles garment, the plaintiff would have that share in it so long as it continued to be carried on by the Newman Company. Under the proposed plan, whether . . . he will continue to have the same proportionate interest will depend upon the will of directors of [Newman] company. When to this fact is added the further consideration that three of the defendants are a majority of the directors of the Miles Company and own a majority of the common stock, which alone has voting power, and that any act they may do as such directors in their private interests may, despite objection by the plaintiff, be validated by their votes as stockholders in a stockholders' meeting, the extent to which the interest of the plaintiff in the portion of business to be transferred to the Miles Company will be subject to the control of the defendant directors is apparent.⁵⁵⁰

(d) *Statutory solutions.*—A statutory solution to the problems raised by split-ups, spin-offs, and split-offs would obviously be desirable. Shareholder approval for split-ups is already statutorily required. Shareholder approval should also be required for spin-offs and split-offs whenever the distributed subsidiary accounts for a significant portion—say 15 percent—of consolidated income or assets. Furthermore (unlike the case of a partial liquidation) none of these transactions result in the release to the shareholders of a portion of their capital, but only in a distribution of stock in a continuing

550 *Id.* at 30, 37 A.2d at 707. Although the principles enunciated in *Klopot* are sound, the result may be questioned because the proposed transaction had been approved by 78 percent of Newman's outstanding common and 54.3 percent of its outstanding preferred, apparently a sufficient number of votes to have amended the certificate. The court said that "even if it be so . . . that the certificate of [Newman] might be amended to include such provisions . . . [T]he very directors who were instrumental in causing the provisions to be inserted in the certificate of incorporation of the Miles Company might not agree to their insertion in that of the parent company" *Id.* at 30, 37 A.2d at 707. However, it would seem preferable to permit the shareholders to approve the creation of a subsidiary with certificate provisions differing from those of the parent, provided the margin of approval is sufficient to have amended the parent's certificate.

corporate enterprise. Therefore, if the distributed subsidiary is very substantial—accounting for, say, 33-1/3 percent of consolidated income or assets (or if none of the subsidiaries distributed in a split-up accounts for, say 66-2/3 percent of consolidated income or assets)—the effect of either a spin-off, a split-off, or a split-up will be a drastic restructuring of a continuing enterprise, and appraisal rights would seem appropriate.

CONCLUSION

In the case of the privately held corporation, legal rules governing internal decisionmaking should be suppletory in nature and based on the shareholders' probable expectations. Shareholders in such corporations probably expect that matters which may be described as "structural" will fall within their province, while matters which may be described as "business decisions" will be for management. Such a distribution of power between shareholders and management is reflected in the received legal model of the corporation. However, it is usually not reflected in the corporate statutes. In terms of coverage, the statutes commonly require shareholder approval for some matters which are not structural, while failing to cover a great many matters which are. In terms of decision-making patterns, the statutes commonly give the board at least concurrent, and usually dominant power over covered structural changes.

Publicly held corporations present a more difficult problem, partly because of the added considerations of public policy based on the great economic power of such corporations taken as a class, and partly because the expectations of shareholders in such corporations as to participating in structural decisions may be weaker than the expectations of shareholders in privately held corporations. On analysis, however, the questions of public policy do not lend themselves to solution through reorganization of the corporate decisionmaking mechanism. Giving shareholders an increased voice would be unlikely to sharpen the corporation's social conscience. Giving corporate client groups a formal role in the decisionmaking process seems neither feasible nor desirable, although it may be desirable to strengthen the hand of such groups in other ways, as by augmenting their negotiating power or conferring new substantive rights upon them. Finally, increasing management's power also seems undesirable. There is no reason to believe that present-day management would use increased power either wisely or unselfishly, and some reason to fear the opposite. Management is deeply self-

interested in questions of structural change, and there is nothing in the education of managers or the process of managerial selection to indicate that managers are expert in questions of public interest. The short of the matter is that it is highly unlikely that business regulation can feasibly be achieved through regulation of internal corporate structure.

If, on analysis, the implications of public policy for the publicly held corporation have been misunderstood, so the expectations of its shareholders have been underemphasized. This is due partly to a misconception about the typicality of corporations, such as AT&T, whose shares are atomistically dispersed, and partly to an undue focus on a relatively unimportant consideration, the expectations of "the average shareholder." The fact that shareholders in most publicly held corporations probably do expect to participate in structural changes, coupled with the difficulty of segregating through statutory definition those relatively few cases where this is not true, indicates that shareholders should be given power over structural changes even in such corporations. This conclusion is reinforced by two considerations based on factors other than shareholders' expectations. First, since management is deeply self-interested and not necessarily expert in questions of structural change, the check of disclosure assumes great importance, and this check is augmented when set in a purposive voting context. Second, voting rights are interrelated with the value of stock, even when shares are atomistically dispersed, because they enable an outsider to acquire control. To the extent that voting rights are minimized, part of this value is effectively shifted from shareholders to management.

Traditional corporate statutes fail to deal with many important structural decisions which are common in today's business world. In some cases shareholders may have voting rights in any event under common law principles or for relatively fortuitous tax reasons. But this is hardly a satisfactory substitute for a well-articulated statute. For one thing, a drastic structural change involving an ongoing enterprise should trigger appraisal rights in privately held and even in most publicly held corporations; but since such rights are generally of statutory origin, they will not be available when common law principles alone are applicable. For another, common law principles leave substantial areas of uncertainty, and therefore interfere with planning. It is accordingly to be hoped that the legislatures and the corporate bar will move to overhaul the corporate statutes so that they adequately cover—as they do not now do—20th century corporate transactions.